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THAT BALANCE-SHEET APPROACH

Edward G. Nelson

All too frequently a university student begins the study of accountancy with a sample balance sheet. After he has mastered a few questionable definitions, he is introduced to the dynamics of business operations through the statement of profit and loss. Once the form and content of the two schedules are outlined, he may explore the records of bookkeepers at great length. In the end, he may have a comprehensive knowledge of ordinary procedures, but he is not, in any fundamental sense, prepared to appraise the work of an accountant.

Such a beginning is conglomerate. It starts with complex subjects and, by a series of rigid rules, proceeds to more simple material. It is usually characterized by numerous illustrations and little, if any, interpretation. There is insufficient training in the ability to recognize the nature of conditions not sharply defined by a text or to understand the implications of a statement already prepared. Astonishingly, there is a confusion rather than a keen differentiation of the qualitative and quantitative analysis so necessary to accurate measurement and adequate display.

There are, broadly, two classes of students in the first course of instruction; the embryo professional accountant and the business man. The first group wants to know what there is to do, how it may be done, and equally well, the significance of the results. The second presumably wishes to understand what the accountant does, to be able to read his statements intelligently, and to judge the quality of his work. Both groups desire the ability to decide when the accountant has, or has not, accurately forecast the probable trend of future enterprise events and, within the limitations of his methods, reliably prepared a statement of profit and loss.

If anything, university instruction should indicate the conditions under which a given procedure is "good accounting practice." The inverted order is of equal importance. Given the results of practice, what are the assumed conditions of operation? Professional students may give some attention to standard practice in the course of their secondary training. The nonprofessional seldom views more than the "given procedure."

Neither group is, on the whole, adequately prepared to analyze the conditions enterprise operation in a manner that is conducive to understanding. Students are taught to account rather than to explain their own accounting. And, unfortunately, an ability in the one does not indicate, among representative sophomores, a capacity in the other. Usually the fault lies in neither the student nor the teacher—it is the result of an illogical approach to the subject.

Although it was not applied to accountancy, there is much to be gained from Professor Fisher's remark concerning the place of the "income concept" in economic science.

> I believe that the concept of income is, without exception, the most vital central concept in economic science and that on fully grasping its nature and interrelations with other concepts largely depends the full fruition both of economic theory and of its application to taxation and statistics.[1]

Professor Canning was more emphatic when he wrote:

> If he (Fisher) had written instead that *income*

[1] Irving Fisher, "Comment on President Plehn's Address," *American Economic Review*, xiv, 64.

is, without exception, the simplest and most fundamental concept of economic science, that only by means of this concept can other economic concepts ever be fully developed and understood, and that upon beginning with this concept depends the full fruition of economic theory in statistics, it would have been an equally true and more significant statement.[2]

The accounting for a balance sheet may be explained, but the statement cannot be understood without first conceiving some elementary notion similar to Fisher's "income" in its general sense. The standard American texts are literal works in accounting. After a preliminary discussion of "business concepts," they usually plunge into a chapter on the balance sheet. Immediately assets are defined as "properties owned by the business," "material goods, claims, and property rights used in the business," or "anything of monetary value owned by the firm whether it be material or immaterial." And, to the reader's amazement, there is no fundamental analysis of wealth or property or any of the ideas underlying the concepts themselves.

Accountants do not act as though they believed assets to be property or the subject of property. The former, in its strict legal sense, is "the indefinite right of the user and the disposition which one may lawfully exercise over particular objects or things."[3] The latter, in Fisher's terminology, is wealth.[4] Wealth and property are correlative terms, but they do not have the same meaning. The property holder has "rights to the chance of the future services of wealth."[5] Wealth, coupled with possession, is "the visible manifestations of invisible rights, the evidence of things not seen."[6]

The value of capital or a set of property rights is determined alone by its future.[7] It is, as of any given time, the present worth of the expected future services. The desired events flow from capital, but the value of capital is not derived from material objects or abstract rights. On the contrary, the value of wealth and, consequently, property is derived from the value of the future services that the instrument is expected to yield.[8]

The material of the balance sheet is the future enterprise services that, as of the given date, may reasonably be expected. To define its elements in any other sense is to ignore the subject of the valuation. Wealth and property are evidence of an expectation, but they are not assets. The accountant does not value "material objects owned by human beings"[9] or "the rights to future services." He is primarily concerned with the magnitude of the future events in which the instruments may participate with benefit to the given proprietor.

Assets are future enterprise services, but all future enterprise services are not assets.[10] The accountant, in order to express a significant sum, uses only the dollar unit of measurement. Some enterprise services may be measurable in other units, but if not in money, they are excluded from the accountant's statements. A personally expressed equivalence between a service and a sum of money is not a satisfactory condition of valuation. The service must be in money or commutable into money.[11]

[2] John B. Channing, *The Economics of Accountancy*, 175.

[3] 22 *Ruling Case Law*, 37.

[4] Irving Fisher, *The Nature of Capital and Income*, chapter I.

[5] *Ibid.*, chapter II. The services of an instrument of wealth are the desirable changes effected (or the undesirable changes prevented) by means of that instrument. *Ibid.*, 19.

[6] 22 *Ruling Case Law*, 37.

[7] Fisher uses the term "capital" to mean "a stock (or fund) of wealth existing at an instant of time." *Ibid.*, 330.

[8] *Cf.*, Fisher, *op. cit.*, 188–189, 202; also his *Theory of Interest*, 14.

[9] Fisher's definition of wealth. See *The Nature of Capital and Income*, 337.

[10] C. E. Sprague, *The Philosophy of Accounts*, 2nd ed., 41, declares that assets are "a storage of services to be received." Professor Canning, *op. cit.*, 22, states that, in general, "the professional accountant's implied definition may be said to be: '*An asset is any future service in money or convertible into money (except those services arising from contracts the two sides of which are proportionately unperformed) the beneficial interest in which is legally or equitably secured to some person or set of persons. Such a service is an asset only to that person or set of persons to whom it runs*'." Since publication, he has withdrawn the condition of legal or equitable security. The holder of a sovereign government's bond can sue only upon the consent of the government. The beneficiary of an illegal contract does not have legal or equitable security. Yet, when there is a reasonable assurance that the service will be rendered, no accountant would fail to treat the item as an asset of the beneficiary.

[11] *Cf.*, Canning, *op. cit.*, 20–22.

A service implies a beneficiary; hence the amount of the future enterprise events is also a measure of the benefits running to recipients. The balance sheet exhibits only one sum.[12] From one point of view, it is the amount of future services that the proprietor may reasonably expect; from another, it is a measure of the entire beneficial interest in the future services. The fundamental equation is an identity. The value of the assets *is* the value of the proprietorship.

The balance sheet usually exhibits the future enterprise services in three different ways:[13] the assets, the interest of the proprietor as a beneficiary, and the services that the proprietor presumably will render to second parties in the course of operations. Quantitatively there are two sums; the amount of the proprietary interest in the future services and the value of the liabilities.

Observe that the two terms are not coördinate nor do they have an independent existence. Liabilities are the future services, valuable in money, that the proprietor probably will render to second parties.[14] They are adverse to the proprietary interest. Net worth, on the other hand, is a measure of the proprietor's *beneficial* interest in the future services.

The two classes form the whole enterprise proprietorship and, since they are categorically identical, the measure of one is the difference between the value of the proprietorship and the amount of the other. Net worth is, however, treated as a residual. It is the difference between the amount of the proprietorship (which is the sum of the assets) and the measure of the liabilities.

Considering the qualitative nature of assets, the entire balance sheet approach becomes questionable. Since they are future services and since the statement is essentially the present worth of a future series, some training in the methods of valuation should precede any quantitative analysis of the accountant's work. No competent instructor would begin his lecture on geometrical progression with a discussion of the sum of a series. Neither would he explain present worths before he examined the nature of compound interest. On the other hand, innocent students are introduced to complex present valuations without so much as an elementary description of the simple series that are valued. The result is a professional rule of law. Fixed assets are valued at cost less accrued depreciation—merchandise is exhibited at cost or market whichever is the lesser.

It is not contended that asset valuations are present worths, but unless the student understands the nature of such measurements, he has no standard with which to compare a particular method. Many valuation accounts cannot be reasonably explained. The balance sheet is wholly a forecast—never an objective determination of provable facts. The value of the assets is no more than a good or bad *index* of the amount of future enterprise services and without the present worth concept, there is no criterion of the good or bad.

The nature, and therefore the significance, of indirect valuations is often lost among the thumb-of-rule methods that are adopted. Take, for example, the case of so-called fixed tangible assets. A proprietor cannot acquire housing or transportation from moment to moment; he must acquire agents to provide the elementary operating services. The accountant's valuation of the asset is, essentially, an estimate of opportunity differences.[15] The value of a given set of future services cannot, at any given time, exceed the cost of the *available* alternative means of providing the necessary events. Each indirect valuation represents the difference to the proprietor between having a given stock of services without a future outlay for it and being without the services at the time of the valuation. It is assumed, of course, that the enterprise will continue operations and that the direct resale value of the agent is less than the opportunity difference.

The failure to analyze indirect and capital valuations may result in a misunderstanding of the nature of revaluations. All elementary texts include a statement of straight-line

[12] *Ibid.*, 48–50.
[13] *Ibid.*, 50.
[14] *Cf.*, Canning, *op. cit.*, 55–56.
[15] *Cf.*, Canning, *op. cit.*, 237–247.

depreciation: many add the sinking fund and annuity methods. Some indicate that accountants use other procedures, but few fully explain their dissatisfaction with the measurements. For the beginning student, the emphasis is placed on procedure. Yet depreciation and obsolescence have an economic rather than a mechanical nature.[16] The variables used in a significant revaluation can be appreciated only when the probable conditions of future enterprise operations are thoroughly studied.

The early use of the fundamental equation has led to much confusion about the nature of revenue and expense. Many authors confuse the measure with the subject of the measurement;[17] others, leaving the student to wonder, are content with no definitions at all. This unfortunate state of affairs cannot be corrected by adopting a uniform terminology. It is the result of an almost universal failure consciously to separate quantitative and qualitative analysis. Writers are too easily satisfied with the general rules of procedure. The postulate—revenue is earned when a sale is made—does not explain the nature of revenue. It is a method of accounting.

To give significance to their statements, accountants should, at least, describe the implications of their methods. What does the figure exhibited as "net sales" measure? Unless there is some answer to the question, it is rather useless to debate the classification of "bad debts." Little that is important can be said about purchase discounts without describing the attributes of operating and financial expense. Even the meaning of "net profit" is sometimes concealed by a strenuous effort to impress the student with "the way it is done."

Paton and Canning have done much to make the statement of profit and loss intelligible.[18] The working papers and reports of professional accountants contain a considerable body of information that could well be added to the secluded field of academic instruction. But, in addition to a qualitative analysis of revenue and expense, there is a pressing need for an analytical survey of the social and individual significance of accounting statistics.

The introductory texts usually include a chapter on "the analysis of accountants' statements," but they seldom go beyond the simple relations of comparative schedules. Business units are no longer looked upon as independent organisms. In these days of widespread interest in the national economy, the student demands more than a study of "operating ratios." He wants to know the social importance of a general increase in corporation profits. What, if any, is the relation between corporate and real income? Does a large earned surplus indicate "security"? Does it show a positive dividend-paying power? What is the effect of a rise in particular price levels on asset valuations?

An indiscriminate use of accounting terminology has contributed, in part, to the confusion surrounding "income" statistics. A serious effort has been made to correct the situation,[19] but there can be no real progress until the instructors of professional students abandon their emphasis on bookkeeping. And when they do so, it will probably be recognized that what is called "enterprise income" is not, in any fundamental sense, an "income" at all.

Accountants are essentially engaged in economic forecasting. Their schedules are statements of opinion about the future of the enterprise: they are not assertions about things that are known to exist. An increase in earned surplus indicates that an increment in the power to pay dividends, at some future time, is supposed to have occurred because certain enterprise activities reached a particular stage (usually sales) during the year. That the increment is positive cannot be proved, as a matter of fact, until the en-

[16] See, for example, L. L. Thwing, "Obsolescence," *The Journal of Accountancy*, XLI, 321.

[17] Revenue is sometimes defined as an increase and expense as a decrease in net worth. The qualities of net worth are those of an arithmetic difference. It is a measure only. A revenue or an expense may *result* in an increase or decrease in the quantity, but neither can itself be a change in the magnitude of a measure.

[18] W. A. Paton, *Accounting Theory*, especially chapter XIX; and Canning, *op. cit.*, chapters VI, VII, and VIII.

[19] See the reports and publications of the Committee on Uniform Terminology, The American Institute of Accountants.

terprise has ceased to exist.[20] The amount of the increase is based upon implicit assumptions about the volume of future enterprise operations and the advantages of future markets for enterprise goods and services.

A surplus in excess of capital contributions is limited, as a fact, to the amount that money receipts exceed money payments, other than transfers between the proprietor and residual beneficiaries, during the life of the enterprise. Since, at any given time during the existence of the enterprise, an earned surplus is a forecast, it is, to all persons beneficially interested, purely a "fiction." And, so long as the enterprise continues to operate, its existence is entirely within the realm of conjecture.

The recent revaluation of surplus accounts with the readjustment of stockholders' and sometimes creditors' interests is evidence of the fallibility of accountants' predictions. Yet, even the distribution of enterprise funds is not, from the beneficiary's point of view, "income" in any real sense. A dollar received or the receiving of a dollar merely enables the recipient to command, at some future time, an increment of service or to ward off an increment of disservice. His "income" exists only when he uses that power.

Professor Canning recently declared that "the first step (in the revision of Fisher's writings) should be to restrict the idea of income to the sense of final objective income, to reserve some word or symbol to denote it, and to employ that word in no other sense."[21] The implications of accountants' procedures will become clear to professional and nonprofessional students only when such a revision is made in the elementary texts. So long as the balance-sheet approach is generally used, the emphasis will be on bookkeeping. A correct journal and ledger will be more important than a good index of enterprise worth and a reliable statement of profit and loss. Objectives will be subordinated to records.

There is, of course, a considerable difference of opinion about the stage of university instruction where the student should be introduced to the economic nature of the accountant's material. Should the procedures of bookkeepers come first? In the opinion of the writer, a larger number of students will understand the significance of accounts if the elements of an economic analysis are presented at the outset of their study rather than as a secondary course. Erroneous and superficial impressions once gained are difficult to correct.

Accordingly a course of instruction should commence with a thorough examination of the nature of economic services and related concepts. The emphasis should be placed on real income. After a clear distinction of qualitative and quantitative analysis, some attention may be given to elementary valuation. A study of the nature of enterprise operations should be succeeded by a survey of revenue and expense. And, after a review of the statement of profit and loss, the elements of the balance sheet may be introduced with a feeling that much may be said about their complex nature without leaving the students in a maze of wonder concerning the intricate procedures of modern finance. Few difficulties will be encountered and but little time will be needed to teach bookkeeping. The students will understand the subject for which they are accounting!

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[20] *Cf.*, Canning, *op. cit.*, 126–127; also J. B. Canning and E. G. Nelson, "Budget Balancing and Economic Stabilization," *American Economic Review*, XXIV, 34.

[21] John B. Canning, "The Income Concept and Certain of Its Implications," *The Proceedings of the Pacific Coast Economic Association*, December, 1932, 62.

DEPRECIATION AND THE FINANCING OF REPLACEMENTS

PERRY MASON

THE BELIEF that it is the principal if not the sole purpose of depreciation accounting to provide for the financing of the replacement of plant and equipment with units of the same type or capacity when the individual items have to be retired from service is widely accepted and frequently expressed. This opinion is now seldom found in technical accounting publications but it is still frequently present in general business, engineering, and legal literature.

Depreciation as a Provision for Replacements. The early publications on bookkeeping and accounting are largely manuals of technical procedure with little to indicate the underlying philosophy or principles. In 1764 John Smeaton, an English engineer, worked out an elaborate schedule for the operation of a canal which provided for an annual income which would cover the "common annual expenses" and would provide a fund accumulated at compound interest by equal annual installments which would "preserve the work to perpetuity" by financing the replacement of parts of the canal as they wore out, although he indicated in a comment at the end of the schedule that the increased trade which could be expected would take care of these irregular repairs without the creation of such a fund out of income. Some of the earlier comments on the operating costs of railways speak of the provision for depreciation as a means of meeting the cost of renewals or replacements.

The treatment of depreciation in discussions of economic principles is often in terms of the replacement of capital assets.

> . . . it is the practise of efficient management to lay aside annually sums which are allowed to accumulate as a depreciation fund for the replacement of their capital goods when they are no longer fit for further use. Neglect to do this eventually results in impaired capital. . . . Consequently, it is sound business practise to regard the maintenance of capital and provision for its renewal as one of the normal expenses of conducting the business. . . .[1]
>
> The manufacturer knows that his machinery wears out, and that if his capital is to remain unimpaired, he must set aside something annually to replace it. . . . If he is to secure a permanent profit, he must reckon these amounts as part of his expenses.[2]

There are many instances in accounting, engineering, and business publications in which depreciation is identified as a provision for financing replacements.

> . . . to provide the necessary funds to replace that asset when it ceases to be productive. . . .[3]
>
> . . . it is self-evident that its cost should have been all charged off against operating, or what is equivalent thereto, a reserve sufficient for its renewal or replacement set up, by the time its usefulness has expired.[4]
>
> If provision be made for depreciation a business can be carried on permanently, for when the original assets are useless, the company is able to replace them.[5]
>
> The company should accumulate funds during the life of the rails for the express purpose of providing for their replacement at the end of their useful life. The only way to be reasonably assured of having such funds when required . . . is to distribute the charge for their replacement over the estimated useful life.[6]
>
> [Depreciation is recorded] in order to create a reserve fund from which to draw the cost of the unit's replacement at the proper time.[7]

An alternative theory is that businesses may be regarded as permanent and that the problem of depreciation is to provide the sums necessary

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[1] Bye, R. T., *Principles of Economics* (1926).

[2] Taussig, F. W., *Principles of Economics* (3rd Rev. Ed.)

[3] Vickerman, W. P., "Depreciation," *Accountant*, Feb. 25, 1905.

[4] Staub, W. A., "Deferred Charges to Operating," *Journal of Accountancy*, October, 1909.

[5] Allen, F. A., "The Necessity for and Method of Providing Depreciation," *Accountant*, May 14, 1910.

[6] Jackson, W. B., "The Depreciation Problem," *Annals of the American Academy of Political and Social Science*, January, 1911.

[7] Saliers, E. A., "Depreciation Reserves vs. Depreciation Funds," *Journal of Accountancy*, November, 1913.

to renew units as such renewal becomes necessary . . . the sum to be provided on the renewal theory is based on probable cost of units.[8]

They should be called replacement charges or replacement funds, for that should be their purpose.[9]

. . . the inevitable result of failing to make proper provision for depreciation is that, when it becomes necessary to renew assets that are no longer in working order, it will be found that enough money has not been saved up to pay for the renewal.[10]

A depreciation reserve can serve but one or the other of two purposes. The first is the insurance of necessary replacement of property; the second is the liquidation of the capital invested. . . . Regulatory bodies . . . should deal with a depreciation reserve only as a means of replacement.[11]

The reserve for depreciation account thus measures the accumulated amount which is reserved for the replacement of the building and fixtures.[12]

There are, of course, opinions to the contrary. For instance:

It is a common custom to describe the annual provision for depreciation of industrial plant as a provision for future renewals, as though it has reference to the future; but this is surely a misconception. The annual provision for depreciation has nothing to do with the future but relates solely to the past. It is a replacement of capital in respect of past capital outlay expired in the process of carrying on the business. . . .[13]

The allowance for depreciation is not inherently a provision for the replacement of an asset. It shows that the asset is worth less than it was at the beginning of the year. Whether the asset is to be replaced or not depends upon the policy of the proprietor.[14]

Depreciation as an Equalizer of Renewal Costs or an Accrued Liability. It is common to find the justification of the periodic charge for depreciation based upon the desirability of spreading a cost which is to be paid in the future, to view it as an accumulation similar to the accrual of interest or other obligations, the obligation in this case being the renewal or replacement of the asset.

Depreciation anticipates the cost of renewals so that the whole of such cost . . . would not be charged against one year when the benefit has been received during many years.[15]

. . . the whole object of making provision in advance for depreciation is to spread the cost of all renewals, partial and complete, equitably over a long series of years. . . .[16]

If a railway company had a track that in, say, ten years wanted £50,000 to renew it, unless they had an amount put by every year, they would not be able to do so.[17]

Depreciation is nothing more nor less than an accounting method of equalizing the cost of replacing and retiring property over a long period of time in order to avoid distorting the operation and maintenance accounts in any relatively short period.[18]

. . . to spread the cost of final renewals as uniformly as possible over the periods benefited, so that we shall not deceive ourselves as to losses and consequently as to profits.[19]

The whole process of providing for depreciation merely consists of withholding from distribution certain moneys which might otherwise have been divided, for the sake of meeting expenditures which will hereafter require to be made to keep fixed assets going.[20]

. . . set up a reserve which merely measures the utility's liability for depreciation which has accrued at the present time but which will be realized at some time in the future.[21]

The depreciation reserve thus created is a recognition of the liability of the undertaking to meet the loss due to depreciation when such a loss occurs.[22]

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[8] May, Geo. O., "The Problem of Depreciation," *Journal of Accountancy*, January, 1915.

[9] Allison, J. E., "A Criticism of Theoretical Depreciation," *Utilities Magazine*, January, 1916.

[10] Editorial in *Accountant*, Feb. 23, 1918.

[11] "Electric Lines File Depreciation Brief," *Electric Railway Journal*, March 1, 1924.

[12] Elwell, F. H. and Toner, J. V., *Bookkeeping and Accounting* (1926).

[13] Leake, P. D., *Depreciation and Wasting Assets* (1912). Also see "Depreciation" in the *Accountant*, Dec. 27, 1913, by the same writer.

[14] Hatfield, H. R., *Accounting* (1927).

[15] Dicksee, L. R., *Depreciation: with Special Reference to the Accounts of Local Authorities*, April 13, 1907.

[16] Unsigned article, "Concerning Depreciation," *Accountant*, Dec. 10, 1910.

[17] Price, W. O., "The Depreciation of Fixed Assets," *Accountant*, April 8, 1911.

[18] Britton, J. A., "Methods of Calculating Depreciation." Correspondence in the *Electric Railway Journal*, Nov. 7, 1914.

[19] Humphreys, A. C., "Discussion of the Depreciation of Public Utility Properties as Affecting Their Valuation and Fair Return," by J. W. Alvord, *Proceedings*, American Society of Civil Engineers, Jan., 1914.

[20] Editorial in *Accountant*, Feb. 23, 1918.

[21] Jirgal, John, "Accounting for Depreciation." Abstract in *Electric Railway Journal*, Oct. 25, 1919.

Depreciation is the accrued liability for the deferred or periodic renewals of plant.[23]

Reproduction Cost as a Basis for Depreciation in Order to Provide for Replacements. It is sometimes maintained that an appropriate basis for the calculation of periodic depreciation is present or reproduction cost, under the assumption that it is the purpose of depreciation accounting to provide for the financing of replacements and thereby to maintain the physical plant out of gross earnings.

The purpose of management certainly must be to maintain the physical plant, and to keep up production without drawing upon capital funds. If this be true, then, when the price level has risen, the charge to operation for renewals should not be the original cost of property retired, but the cost of new property which, in function and capacity, is required to replace the old.[24]

The owner of property is as much entitled to the maintenance of the integrity of that property as is the owner of the bond entitled to the maintenance of the integrity of his monetary claim. . . . The integrity is secured in two ways—by physical maintenance and by the provision from current earnings of a fund which will permit its replacement when its service life is ended.[25]

No Logical Connection Between Depreciation and Replacements. If it were the sole purpose of depreciation accounting to provide for the replacement of assets, logically there would be no depreciation to record if the asset were not to be replaced. The problem of depreciation arises because of the necessity of taking into account the fact that the investment in an asset has been reduced to scrap value at the time of its retirement from service in order to arrive at the net profit for the period or periods involved. It is the accounting for a past expenditure, not a provision for a future one. The relationship between depreciation and replacements is purely coincidental—most assets are replaced at the time of retirement.

Often Impossible for Results of Depreciation Accounting to Finance Replacements. The effect of depreciation accounting upon the funds which might be available for the financing of replacements has been discussed in detail elsewhere.[26] It was shown that only if there is no net loss can it be assumed that assets have been retained equal to the amount of depreciation charged off as an expense during a given period, and that unless conscious steps are taken to build up a fund of liquid assets, there is no reason to expect that the retained assets will be readily available for the purchase of new assets. It is true, however, that if funds have been retained in the business, the ability to finance replacements has increased; for even though liabilities have been decreased or fixed assets have been increased, instead of having created a fund of liquid assets, the company should be in a better position to borrow money for the actual financing of the replacements.

The assumption that a proper depreciation charge will somehow provide the funds necessary for financing replacement runs into difficulties during periods of rapidly rising prices. The following illustration will demonstrate the problems which arise at such a time. Let us assume that a machine is purchased at a cost of $5,500, that it will last for 10 years, that it will have a scrap value of $500, that the straight-line method of calculating depreciation is used, and that the following are the costs of purchasing the same machine at the end of each of the years of its life.

1st year	$5,600
2nd year	5,800
3rd year	6,000
4th year	5,800
5th year	6,200
6th year	6,200
7th year	6,800
8th year	7,000
9th year	6,500
10th year	7,500

At the end of the first year depreciation on original cost would be $500 (10% of $5,000); if based upon the present cost, it would be

[22] Erickson, Halford, "Depreciation." Address delivered before the convention of the Cent. W. W. Association, Sept. 25, 1912.

[23] Humphreys, A. C., "In Rate Fixing by Commission Should 'Depreciation' Be Deducted from Plant Valuation." Abstract in *Electric Railway Journal*, Oct. 31, 1914.

[24] Bauer, John, "Renewal Costs and Business Profits in Relation to Rising Profits," *Journal of Accountancy*, Dec., 1919.

[25] "Colloquy on Depreciation Accounting." Editorial in *Railway Age*, Aug. 2, 1930.

[26] See the author's "The Financial Aspects of Depreciation Accounting," in the ACCOUNTING REVIEW, September, 1935.

$510 (10% of $5,100). At the end of the second year depreciation based upon present cost would be $530, but since not more than $510 was charged off the first year there is a $20 deficiency which must be made up during the remaining nine years or charged against surplus from operations. The depreciation must be raised to $532.22 if a total of $5,300 is to be charged to operations. At the end of the third year a similar situation exists and a normal depreciation, based upon present cost, of $550 must be raised to $557.22. At the end of the fourth year the amount deducted at the end of the third year now appears to have been excessive, and spreading this apparent excess over the remaining seven years would give a depreciation charge for the fourth year of $528.65. The following table shows the results of such a plan for the ten-year period together with a comparison of the annual depreciation based upon original cost and upon present cost without adjustment for previous deficiencies or excesses.

End of Year	*Depreciation Based on Original Cost*	*Depreciation Based on Present or Reproduction Cost*	*Depreciation Based on Present or Reproduction Cost, Adjusted for Past Deficiencies or Excesses*
1st	$ 500.00	$ 510.00	$ 510.00
2nd	500.00	530.00	532.22
3rd	500.00	550.00	557.22
4th	500.00	530.00	528.65
5th	500.00	570.00	595.32
6th	500.00	570.00	595.32
7th	500.00	630.00	745.32
8th	500.00	650.00	811.99
9th	500.00	600.00	561.99
10th	500.00	700.00	1,561.97
Totals	$5,000.00	$5,840.00	$7,000.00

It is apparent that merely basing the depreciation calculation upon the reproduction cost (column #2) will not insure the retention of assets equal to the cost of replacement. An adjustment of this figure so as to provide the full replacement cost (column #3) not only gives results which would be too erratic and unreasonable to be acceptable as periodic cost or expense charges, but it would have the expected result on the funds available for financing replacements only under the assumption that the usual net income would cover such charges. It might not be unreasonable to expect that the sales figure would cover the $5,840 shown above as depreciation based upon reproduction cost, for in general selling prices reflect current costs, but there is no reason to believe that in a competitive situation prices could be raised high enough to cover the adjusted figures so as to accumulate the full $7,000. If there is no net income after charging depreciation on the basis shown in column #2, or if it is assumed that the net income and surplus are not to be reduced, it is absolutely impossible to finance replacements by means of charging depreciation on the basis of reproduction cost during a period of rising prices.

Depreciation as an Appropriation of Net Income. It is frequently suggested that depreciation should be a charge against net earnings rather than a deduction which must be made before the net income for a period is determined, and from this the logical deduction is made that if there are no net earnings, there can be no charge for depreciation. This conception of depreciation depends for its validity upon the assumption that the purpose of recording depreciation is to accumulate a fund, actual or potential, for the financing of retirements.

> That I had not set aside anything before was . . . because . . . there were no profits available out of which sums could be laid aside.[27]
>
> . . . provision has been made to cover . . . depreciation out of the earnings of the operation.[28]
>
> If depreciation has to be recorded, it should be made as a deduction from the income account, rather than charged to operations. . . .[29]
>
> Depreciation should be charged to Income rather than to Operating Expense because (1) depreciation is not an "expense" because it may not involve the payment of money, and depreciation goes on independent of operation, especially obsolescence.[30]
>
> If the operating expenses include any bookkeeping debits which do not represent actual transactions, the net revenue is understated.[31]

[27] "Depreciation in Municipal Trading Accounts." Correspondence in *Accountant,* June 8, 1901.

[28] Gundry, W. H., "Depreciation of Assets," *Accountant,* Aug. 26, 1905.

[29] Delano, F. A., "The Application of a Depreciation Charge in Accounting," *Journal of Political Economy,* November, 1908.

[30] Royse, Daniel, "Depreciation in Electric Railway Accounting," *Street Railway Journal,* April 25, 1908.

[31] Nay, Frank, "Income Account of Railroads." Correspondence in *Railway Age,* April 17, 1908.

. . . the amount set aside out of the profits of a corporation . . . the transfer might just as well be from "Surplus Account" to an account called "Surplus Account No. 2," it being understood that the No. 2 account constitutes a safeguard against an over-valuation of the plant until it is entirely wound up.[32]

The car-riders of each month or year should pay a toll or rate of fare sufficient to enable the company to pay its operating expenses, its taxes, a fair rate on its investment, and, in addition, to set up out of the earnings . . . a reserve sufficient to take care of the depreciation. . . .[33]

If these reserves are to be created by charges to operating expenses, and net income is not large enough to stand the full amount required, there should be charged all that the net will bear, even if it is only a small amount per month for each account.[34]

The published income statements of public utilities often show depreciation as a deduction from net income and occasionally the same practice is followed in other types of enterprises.

If it were the purpose of depreciation accounting to provide for the financing of replacements, the entry could properly be made as a deduction from net income, for if there is no net income the entry has no effect upon the available funds and apparently becomes meaningless.

Replacements Charged to Depreciation Reserve. The suggestion frequently is made that the proper way to handle replacements is to charge the cost of replacing an asset (with another of the same kind or capacity) to the reserve for depreciation. This is entirely consistent with the concept of the depreciation reserve as an accrued liability.

. . . when replacements or renewals . . . are made, the cost should be charged against depreciation reserve.[35]

When property has to be renewed the cost new of the same, less scrap value, is charged to the depreciation reserve and credited to the cash account.[36]

The final renewals are made as required and the cost debited to the renewal reserve account.[37]

There is no reason to believe that the amount accumulated in the reserve for depreciation will often correspond to the cost of replacement or that the required amount of funds for purchasing new equipment will be retained. During rising prices too small an amount will be accumulated unless appropriations of net income supplement the regular expense charge, and during falling prices more than the amount required for replacement will appear in the reserve account.

Such a practice, if followed consistently, would leave the asset accounts which record the amount of the plant and equipment always at their original cost unless these accounts were systematically written up or down with corresponding adjustments of capital surplus.

Useless Depreciation Reserves. The belief that depreciation reserves are often excessive when accumulated by the use of the usual accounting procedure, has been applied primarily to the problems of public utility accounting and valuation; but it can be pointed out here that the idea of a useless reserve, as it is usually presented, assumes that the purpose of depreciation accounting is to provide for replacements and that the recording of depreciation will inevitably accumulate funds available for that purpose.

The concept of a useless reserve is usually stated somewhat as follows: in the case of property consisting of a single unit, the entire cost ought to be accumulated in a depreciation reserve, but when the plant consists of a large number of items so that the replacements are approximately the same each year, a reserve equal to a small percentage of the total cost of the plant will be entirely adequate to equalize the replacement charges and provide the necessary replacement funds. The use of the total accrued depreciation creates a reserve with a permanent balance which may amount to forty or fifty per cent of the total cost and only a

[32] Stockwell, H. G., "Depreciation, Renewal and Replacement Accounts," *Journal of Accountancy*, January, 1910.

[33] Davies, H. J., "Fair Interest on Investment in Public Utilities," *Journal of Accountancy*, January, 1910.

[34] Silliman, F., Jr., "Accounting for Depreciation." Abstract in *Electric Railway Journal*, Dec. 1, 1917.

[35] Duffy, C. N., "Depreciation." Digest of paper in *Street Railway Journal*, Feb. 1, 1908.

[36] Erickson, Halford, "Depreciation." Address delivered before the convention of Cent. W. W. Association, Sept. 25, 1912.

[37] Thomas, J. J., "Depreciation and Valuation," *Journal of Accountancy*, January, 1916.

small part of the funds represented by this reserve will be used for making replacements —the balance is useless.

This company stated that it was willing to maintain the efficiency of its equipment, but that it had a most decided objection to accumulating funds of idle money to represent a depreciation that does not affect the usefulness of the cars or locomotives.[38]

A study of any theoretical depreciation curve will show that if the theoretical depreciation charges have been made from the installation of each item, the accumulation in the depreciation fund will always equal the amount of depreciation, i.e., the sum of the depreciated value, and the accumulated fund will always equal the original investment, and, when on account of the straightening out of the curve along the normal age line there cease to be any wide fluctuations for large renewal at any one time, then a great part of the fund will be a needless accumulation as it can never be used for replacement or renewal.[39]

... the existence of a depreciation reserve does not insure the existence of a body of "idle cash" or of easily convertible assets held against possible replacement needs. But it does make it certain that all needed replacements *up to the amount of the reserve* may be made without either cutting into surplus or increasing the deficit for the year. In practice the reserve for the depreciation of large and varied properties becomes much larger than can be "used" in this way for replacements, and to this extent is "unnecessary" for replacements.[40]

It is not necessary to start a depreciation reserve during the earlier years of operation, as an accumulation started after say ten years, when the business has become comparatively stable, will be found sufficient for normal requirements.[41]

On account of the equalization of renewals, the use of the straight line method, life tables, etc., results in the accumulation of an enormous fund for which the utility would at no time during its future life find a legitimate use.[42]

... of questionable wisdom to attempt to collect ... a theoretical amount for an unnecessary and unjustified excess depreciation.[43]

If the problem of accounting for depreciation were merely to finance replacements, the retention of funds equal to the total accumulated depreciation would often be unnecessary or "useless," for it is true that in a complex, seasoned property the entire plant or even a large portion of it is not retired in any one period and the replacements do tend to even up over the years so that a fund much smaller than the total accrued depreciation would adequately finance the purchase of new units to replace the old ones. But such a fund could best be accumulated on an irregular basis such as building up the fund in prosperous years, making no additions in some periods, and so on, which would make it impossible to treat depreciation as an item in cost or periodic expense accounting.

The appearance of uselessness of the depreciation reserve is less apparent if the total accumulation is broken down so that there is a separate accumulation for each type of property. This is the usual practice in modern industrial accounting and often the depreciation is assigned to individual units in the subsidiary plant accounting records. When there is a reserve for depreciation for a particular unit it is obvious that all of it will be needed to cover the total amount of the retirement and none of it will be useless unless an error in the estimates has led to an excessive charge. As an accumulation of amounts charged to expense in order to write off the investment in an asset over its life, none of the reserves for depreciation can be useless or unnecessary. If the earlier years are charged with their share of the burden, the creation of a permanent reserve is usually inevitable.

While it may be true that in some situations more funds may be retained than will be needed for the financing of replacements, it can seldom be true that such funds cannot be used to good advantage. The expansion of plant, the reduction of liabilities,

[38] "Hearing on Depreciation of Equipment Accounts," by I. C. C. *Electric Railway Journal*, July 4, 1908.

[39] Allison J. E., "Depreciation," *Annals of the American Academy of Political and Social Science*, May, 1914.

[40] Young, A. A., Reply to criticism of "Depreciation and Rate Control," *Quarterly Journal of Economics*, February, 1915.

[41] Nash, L. R., "Depreciation Reserves as Affected by Property Growth," *American Economic Review*, March, 1916.

[42] Maltbie, W. H. Correspondence in *Electric Railway Journal*, Dec. 9, 1922.

[43] Burke, J. W., "Determining Utility Depreciation on a Logical Basis," *Electric Railway Journal*, October, 1930.

or the strengthening of the current position might well be brought about by the use of the funds thus made available. As one writer has said: "Granted that the reserve for accrued depreciation will never be 'used up' as replacements are made, what of it?"[44] The entire property of an enterprise can ordinarily be used in some productive activity and none of it is "useless."

Conclusions. The financing of replacements is an important problem in the financial administration of a business enterprise but it is quite distinct from the problem of accounting for depreciation. The conception of the two as being identical leads to an irregular provision which has no relationship to the use made of the assets, and it would make it impossible, or at least illogical, to provide for depreciation during periods in which there is no net income or when the asset was not to be replaced.

The financial results of depreciation accounting, the fact that if the gross income is large enough to cover all expenses, including depreciation, net assets will be retained in the business equal to the amount of depreciation charged off, may be correlated to a certain extent with the financial provision for replacements. Just as the maker of the financial budget may plan to spend a certain amount for extension of the plant or retirement of obligations, obtaining the funds by retaining net income in the business by means of a policy of limiting dividends, so he could plan to spend an amount of money equal to the depreciation charged off during the period for any desirable purpose such as the purchase of new equipment to replace that which is to be retired. The amounts required for replacements in any one period, however, would not often correspond to the amounts charged off for depreciation, for even in the case of railroads where the highest degree of uniformity in replacements might be expected to exist, there is a decided tendency to allow replacements to fluctuate with the prosperity of the company; and the amount required for a revolving fund to insure the adequate provision of funds for replacements would almost invariably be much smaller than the total accumulated depreciation.

It is not difficult to understand why so much confusion should have arisen between the problems of depreciation and replacement of units of property with like units; the treatment of depreciation as a provision for an accruing liability and the charging of the cost of replacement to the depreciation reserve might very well give results which were identical with those obtained by the more orthodox accounting procedures. The necessity of providing for replacement looms up in a highly realistic manner in the practical conduct of a business enterprise while the provision for depreciation has somewhat of an abstract, academic appearance. Even the terminology which has come to be used, especially the term "reserve for depreciation," requires a technical interpretation. There is no easier way to convince the owner of a business that he should include depreciation as an expense than to point out that if he does not he will not have the funds to purchase a new machine when the old one wears out. If an enterprise does provide for replacements out of earnings it can stay in business indefinitely and whether it considers depreciation an operating expense, a cost of production, an appropriation of earned income, an accrued liability, or an amortization of investment may have little to do with its chances for survival. No business ever got into serious trouble by setting aside funds to be used for the replacement of its assets but there are many which have experienced financial difficulty as a result of an unprofitable expansion which exhausted their available funds and left them unable adequately to handle replacements.

The philosophical concept of depreciation as a provision for replacements, however, is indefensible. It is illogical, it leads to an inequitable distribution of costs, and to misleading statements of income and financial condition.

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[44] Davis, J. S., "Criticism of Depreciation and Rate Control," by A. A. Young, *Quarterly Journal of Economics*, February, 1915.

ACCOUNTING PRACTICE UNDER THE SECURITIES AND EXCHANGE COMMISSION

C. Aubrey Smith

The Securities Act of 1933, designed to compel full and fair disclosure of material facts relating to securities publicly offered and sold in interstate commerce, has been in operation now some 26 months, during which time approximately 1,700 issues of new securities have been registered with the Federal Trade Commission and its successor, the Securities and Exchange Commission.

The Securities Exchange Act of 1934, which transferred the administration of the Securities Act from the Federal Trade Commission to the SEC, in addition to continuing the activities of the Federal Trade Commission relative to the Securities Act, is also concerned with the registration of security exchanges, the registration of securities on national security exchanges, and the making of studies and the promulgation of rules relative to certain practices looking toward the public interest and the protection of investors.

The public accountant has a direct professional interest in at least one division of this Commission—the registration division. Since the registration requirements covering new issues under the Securities Act and securities listed on national exchanges under the Securities Exchange Act demand financial statements certified by independent public accountants, it is imperative not only that the public accounting profession be kept fully informed as to the statutory requirements as set out under the Commission's rules and regulations, but also that it keep abreast of the policy of the Commission with respect to accounting practices.

You may be interested in some statistics secured from registration statements filed under the securities Act of 1933. As of September 1, 1935, 1614 registration statements had been filed. Of this number 1,188 became effective, 58 were under stop orders, 1 was under refusal order, 41 were under consent refusal order, 240 had been withdrawn, and 86 were under examination. Of the 1,614 total, 1,205 bore financial statements certified by independent accountants. As to the accountants certifying, 937 were signed by certified public accountants or members of the American Institute of Accountants, 51 were signed by Canadian chartered accountants, and 217 were signed by public accountants not certified and not members of the Institute. A further analysis of these accountants' certificates indicated that 392 were from national firms (defining a national firm as one having offices in more than one state), while 813 carried the certificates of local accountants or firms of local accountants. Geographically, these certificates originated in 43 states of the Union, one territory (Alaska) and Canada. Texas ranked 14th in the list.

As of a recent date some 2,300 permanent registration statements under the Securities Exchange Act, of the Form 10 to Form 21 varieties, had been received in the offices of the Commission. Since, however, the financial statements accompanying these forms have not been completely examined by the Commission's staff and since the accounting requirements under this Act are not so strict as under the Securities Act, this discussion will be limited to accounting practices arising from the administration of the Securities Act of 1933.

ORGANIZATION OF THE REGISTRATION DIVISION

In order to understand the operation of the Securities Act as it affects accounting practice, it is essential that a picture be secured of the manner in which the registration division functions. Procedure in this division will be briefly outlined at this point. Reporting to the Commission is a Director of the division under whom there are four assistant directors—one detailed to special

work under the Exchange Act for permanent registrations, one who functions somewhat as a legal adviser to the division and who is responsible for all stop-order proceedings, and two assistant directors who are concerned particularly with reviewing data going to and coming from registrants and conferring with registrants. Below these two assistant directors are six examining groups, each of which is headed by a security analyst, assisted by an accountant and an attorney. There are from three to five examiners in each examining group. One of these groups is a specialized unit and examines only public utility filings. The other five groups examine in the order of filing any and all registration statements filed other than the utility issues. Also maintained in this division is an engineering staff the duties of which consist in examining such property valuation data as may be included in registration statements.

The actual examining work begins after the statement has been properly registered and docketed. The security examiner's first problem is to determine whether the statement has been filed on the proper form. After having satisfied himself on this point, he goes to work examining the various items on the registration statement. On legal questions he confers with the group attorney, on accounting questions with the group accountant, after which a deficiency report is prepared by the examiner initialed by the attorney and accountant. Since the registration statements become effective on the 20th day from date of filing unless amendments are made thereto, it is imperative that these deficiency reports be prepared and in the hands of the analyst within five days. The analyst then studies the deficiency report and, in conference with the examiner and his accounting and legal advisers, prepares a letter of deficiency. This letter of deficiency together with all documents filed by the registrant goes to the assistant director, who gives it a further check. If there are no debatable questions involved, the letter goes out over the signature of the director. If disagreements have arisen over any of the items which the assistant director is unable to settle satisfactorily, a conference is held with the director. If still there is no substantial agreement among the staff, or if the question involved is one of policy which has not been fixed, the matter at issue may be taken up with the Commissioners. It may be pointed out in passing that the number of registration statements filed on which no deficiencies are called is almost negligible. It should also be mentioned that the questions which occasion the greatest amount of argument and debate in this division of the Commission are those relating to accounting practices and financial statements.

If the amended statement upon examination has met all deficiencies, the statement is cleared within 20 days from the filing of the last amendment. The Commission may, however, accelerate the effective date of the statement under the provisions of Section 8(c) of the Act. The clearance process consists in having the examiner prepare a clearance report signed by the accountant, examiner, attorney, and analyst in which is incorporated all significant information which may be required by the Commission, including the material deficiencies called and how well these deficiencies have been amended. The assistant director personally takes these cases before the Commission sitting as a group. He presents orally relevant information concerning the method of financing and the financial set-up, and he answers any questions concerning the registration data which the Commission may ask. While the great majority of these registration statements are cleared at these meetings, it is not unusual for the Commission to postpone clearance, asking for further information, or, sensing a vicious piece of financing, asking for a further review of the case looking perhaps toward a stop order.

"What," you may ask, "follows if the registrant fails or refuses to amend his registration papers within the 20-day period, thus permitting his deficient registration statement to become effective by lapse of time?" The answer is that proceedings will be instituted to determine whether the registrant shall be restrained from issuing the security registered on the basis that the statement in-

cludes misleading or untrue statements of material facts or omits to state material facts required to make the statements therein not misleading. Since the issuer is liable both civilly and criminally for selling securities if these facts are proved, it is obvious that he will not sell until he has a legally effective statement.

ACCOUNTING REQUIREMENTS

The question in which we as accountants are interested is, "How do the requirements of this Act affect accounting practice and what have been and are likely to be the effect of these requirements on accounting practice?"

There are at least five ways in which the public accountant is limited or restricted in practicing before this Commission. These are as follows:

1. The Act itself.
2. Rules and Regulations of the Commission as they affect accountants and accountants' certificates.
3. Forms and instructions accompanying the forms prepared by the Commission to be followed by the certifying accountant.
4. Published opinions and findings of the Commission.
5. Opinions and rulings of the Commission involving interpretation of forms and instructions relating to financial statements —not published. Each of these will be discussed briefly.

The Securities Act of 1933

Section 19 of the Act provides that the Commission shall have authority to define accounting terms, to prescribe forms in which required financial information shall be set forth, the items or details to be shown in the balance sheet and earning statement, the methods to be followed in the preparation of accounts, and the valuation of assets and liabilities.

The language in this section is clear and unequivocal and says in substance that this Commission may not only decide what are accepted accounting principles but may even promulgate and publish what the practitioner shall consider accepted accounting principles if his financial statements are to be accepted as a part of registration statements filed with the Commission. The Commission has not as yet availed itself of the opportunity to draft rules of accounting other than certain minimum requirements under the various forms. Whether it will eventually do so one cannot at the present time hazard a guess. I think I can say unequivocally that the temper of the present Commission is to permit the accountants to draw up for themselves what they shall consider "accepted accounting principles and practices." If the practitioners, after sufficient time has elapsed, have not come to some substantial agreement as to what are or should be considered accepted accounting principles and practices, we may well expect the Commission's staff accountants to prepare, and the Commission to publish what it shall demand in the way of such practices. Since every prospectus to be used in the sale of new issues of securities in interstate commerce must bear financial statements satisfactory to the Commission and since every security listed on an organized exchange must like-wise be accompanied by a permanent registration statement which includes financial statements prepared and certified in accordance with the Commission's requirements, it is manifest that if the Commission takes upon itself the task of setting standards of financial accounting, then these standards will become the authoritative and accepted accounting practice of the nation.

Rules and Regulations of the Commission

The public accountant certifying to financial data included in registration statements has no particular interest in the rules and regulations of the Commission under the 1933 Act other than Articles 14, and 15 as amended. Article 14 defines whose certificates the Commission will recognize. Article 15 states the requirements of certificates presented. These requirements are five in number as follows:

1. The certificate shall be dated.
2. The certificate shall be reasonably comprehensive as to the scope of the audit made,

3. The certificate shall state the opinion of the accountant or accountants in respect of financial statements presented.

4. The certificate shall state the opinion of the accountant or accountants relative to accounting principles and procedures followed by the registrant.

5. The certificate shall refer to any financial data in the registration statement proper to which reference is required in the financial statements.

This last requirement relates specifically to items to which reference is required on the balance sheet. Since forms other than A-2 do not require such reference and since this part of Article 15 does not apply to Form A-2, this requirement is entirely meaningless at the present time. Perhaps as new forms are prepared this requirement will take on some significance.

Requirement No. 4, the opinion of the accountant relative to accounting principles and practices followed by the registrant, is the cause for much debate and misunderstanding between the certifying accountant and the Commission's examiners. Many of these certificates are so worded that the reader cannot determine whether the accountant is disclaiming knowledge, is merely indicating that legitimate difference of opinion exists, or that he is in disagreement with the client as to the treatment accorded the item or items in question. As an example, this sentence was included in a recent certificate on an A-2 filing: "In our capacity as independent accountants, we have not undertaken to pass upon and assume no responsibility for—adequacy of provisions made for depreciation, depletion, maintenance, repairs, renewals and retirements." Just what is the auditor intending to say in this circumstance? Is he intimating that he disagrees with the accounting procedure for depreciation, renewals, and repairs and that he does not have the intestinal fortitude to speak out definitely; does it infer that he is incapable of verifying these items; does it imply that the nature of the business is such that he, as an accountant, cannot honestly express an opinion; or does it signifiy that he does not consider the verification of these items as being within the ambit of the auditor's duty? Lack of time prevents the citing of many other certificates received with registration statements in which the independent accountants fail to set out clear-cut, straightforward opinions as to the issuer's accounting practices.

Forms and Instructions Concerning Forms

In the preparation and promulgation of accounting requirements of Forms A-1, A-2, C-1, and E-1 under the Securities Act and Forms 10 to 21 under the Securities Exchange Act the Commission has had the aid and guidance of outstanding public accountants, company comptrollers, and experts from the financial reporting agencies. Form A-2, released January 12, 1935, has been particularly well received by public accountants. Commenting on this form which purports to be a simplification of Form A-1 for those corporations eligible to use it, the *Accounting Review* declared: "The SEC has in one month set definite and on the whole reasonable standards for the (accounting) profession which years of futile committee work within professional societies have not been able to produce or even begin to produce." While this form suggests standard, conservative, and prevailing accounting practice, it should also be pointed out that it fails to incorporate certain requirements for which the better practitioner has been striving during the past fifteen years. As illustrations the following are cited:

1. Treasury stock may be shown as an asset provided a reason is given for such treatment. The usual reason given is that such is the company's regular practice. No more need be said.

2. Discount on capital stock may be shown as an asset, but subscriptions to capital stock must be reflected in the capital stock section of the balance sheet.

3. Reacquired no par value stock, if deducted from capital stock, surplus, or capital stock and surplus, must be shown at cost. Average issue value, stated value, or specific certificate value of such stock is apparently not permitted.

4. Then there is surplus. You may recall

how this instruction reads. For those who may have forgotten, permit me to quote from item 32 of the instructions to balance sheets. "Show in the balance sheet the division of this item into (a) paid-in surplus and/or (b) other capital surplus; and (c) earned surplus; however if, in the accounts of the registrant, separate balances for these are not shown at the beginning of the period of report, i.e., if the company has not, up to the opening of the third fiscal year prior to the last annual closing date, differentiated in its accounting for surplus as indicated above in (a) and/or (b) and (c), then the registrant may state the surplus in one amount." Two examples found in regulation statements will clarify my objection to this surplus practice.

a. A company carried its one surplus account into the balance sheet, indicating a credit of some $700,000. From supplementary information it was discovered that a few years prior the company had credited approximately a million and a half to this same surplus account arising from unrealized appreciation of properties. In reality the company had an accumulated operating deficit, but since this write-up had occurred prior to the three-year period of report and since it had been merged on the books of the company, there was no question but that it met the requirement of this item.

b. Another case is that of a concern which in merging two corporations placed no value on the common no par value stock issued in part payment for the net properties taken over, but credited the difference to an undistinguished surplus account.

It seems to be that, instead of permitting the accumulation of all equity value in excess of capital stock in one surplus account, the instructions should require a breakdown of the surplus account into its various surplus elements, at least during the period of report and probably from a period five years prior to report if not from the inception of the company. Many accountants are of the opinion that in its zeal for statement simplification the Commission has taken accounting practice back several years in permitting the exhibition of a surplus account which not only fails to give a true surplus history, but may actually through inference set out a misleading statement of surplus—on the theory that the layman considers surplus standing alone has the significance and attributes of earned surplus.

Published Findings in Stop-Order Proceedings

A study of those cases in which the Commission has rendered published opinions in stop-order proceedings leads inevitably to the conclusion that the Commission, in such cases, has followed conservative and generally approved practice. Several of these decisions will be briefly noted:

1. In Unity Gold Corporation it was held that where stock was issued for property the actual value of which was not proved, if a part or all of such stock so issued was returned to the treasury as a donation concurrent with the purchase of the property, such donated surplus really represented a reduction in the original property value and should be deducted therefrom rather than reflected as a capital surplus item on the balance sheet.

2. In Haddam Distillers Corporation it was held that *pro-forma* balance sheets giving effect to proposed financing are misleading in the absence of a firm commitment to take down the securities to be offered.

3. In General Income Share, Inc. it was held that donations to the corporation, even of current assets, should not appear in the profit and loss and earned-surplus accounts but should be reflected rather in a capital surplus account, perhaps under the donated surplus grouping.

4. In Brandy-Wine Brewing Company it was held that promotional services carried on the balance sheet as an asset at the par value of capital stock issued therefor will not go unchallenged by the Commission if it is discovered that such a value is "so grossly and indefensively excessive as to be outside the range of reasonable difference of opinion." It was therefore held that a large part of the stock was passed to the promoter as a gift and that to show the entire amount as an asset on the balance sheet resulted in an untrue statement of material fact.

5. In Plymouth Consolidated Gold Mines

Ltd., it was clearly indicated that a balance sheet which purported to show property owned by a subsidiary as its own property (without designating such statement as a consolidated balance sheet) would not be acceptable to the Commission.

Rulings Relating to Financial Statements, not Published

The accounting philosophy of the Commission cannot be discovered entirely from reading stop-order cases or from studying the forms, and the instructions concerning the forms on which registrants are required to submit financial statements. A knowledge of how the Commissioners have reacted to controversial, incorrect, or debatable accounting principles brought before them by the Commissioners' examiners and how these questions have been finally dealt with in regisration statements is essential if one is to understand fully what effect this Commission is having on accounting practice. It should be made clear, however, that many of the accounting practices questioned by the Registration Division are either passed upon by the employees of the Commission or are settled in conferences between these employees, representatives of the firm certifying the accounts, and representatives from the issuing corporation and from the underwriters. Under these circumstances even though the Commission does not as such pass upon all controversial accounting matters, the policy and philosophy of the Commission is carried out so that one may say that the accounting practices accepted by the registration division are in reality those practices which it may be inferred would be accepted if put before the Commission as a body. A few illustrations will best set out this philosophy.

Perhaps the first questionable accounting practice concerning which a decision was made by the Commission had to do with writing bond discount and expense off to capital surplus arising from appraisal. The more orthodox practice would of course require an amortization of such discount and expense over the life of the bonds on which the discount had arisen. You will no doubt recognize this situation as that which arose in the now famous Northern States Power case. In deciding by a vote of 3 to 2 that a correction of the financial statements submitted would not be required, but in lieu thereof a footnote should be added to the financial statements affected, stating what the profit for the years of report and the present earned surplus would have been had the orthodox method of accounting been employed, the Commission set an accounting precedent which has since been followed with consistent regularity.

In a later case, the Commission's examining accountant took violent exception to an accounting practice which he thought was inconsistent and misleading, insisting that the balance sheet and income statement be changed to reflect a more conservative practice. Briefly, these are the facts: A large manufacturing company wrote off the abandoned part of its plant and equipment to a Reserve for Retirements which reserve had been created the year previous by a charge to capital surplus arising from writing down its capital stock. Some four or five years prior to this date, a portion of this same plant had been sold at a profit, the profit so secured having been credited to earned surplus. The certifying accountant in his certificate mentioned these facts but expressed no opinion as to whether or not they had been properly accounted for. After having run the gamut of examiners, staff accountants, analysts, assistant director and director of the registration division, the matter was finally presented to the Commissioners for their opinion. The final result was that no change would be required in the financial statements but that the accountant must express an opinion as to the accounting practice and state what effect such practice would have on its earned surplus account. Following this suggestion the certificate was amended to include this paragraph:

"We are of the opinion that it would have been preferable to make such charges against earned surplus, and in such event the earned surplus and paid-in surplus of the registrant at December 31, 1934, would have been

$3,311,321.20, and $7,506,986.59, respectively. . . ."

This same principle was adopted in the case of a large credit company which in liquidating a foreign subsidiary incurred a loss of approximately five and one-half million dollars, which loss was charged to capital surplus. Here again the Commission was satisfied with a footnote to the financial statements affected stating what the amount of earned surplus would have been had the loss been charged to earned surplus rather than to capital surplus.

In another surplus situation an incorporated investment trust of the management type charged a sizeable loss from sale of securities to capital surplus. When the registrant advanced the argument that such loss was a capital loss and hence properly chargeable to capital surplus, even though profits and losses from sales of securities would be a normal annual recurrence, the Commission raised no objection to the treatment. The certifying accountant had fully protected himself by a statement in his certificate as follows: "from an accounting viewpoint such losses constitute a charge against earned surplus."

Another interesting case in which the Commission refused to require a revision of financial statements even though the registrant's accounting practices appeared to result in false, misleading, deceptive and inconsistent statements of material fact will be briefly outlined. The registrant, a holding company, acquired a 100% interest in one operating subsidiary and a 97.12% interest in another such subsidiary. On its balance sheet, the investment in the wholly owned subsidiary was carried at book value at date of acquisition which amount was in excess of cost. The excess of book value over cost was credited to capital surplus. At the date of the registrant's balance sheet this book value had decreased although no entry had been made giving effect to the reduction. The investment in the almost wholly owned subsidiary was carried at cost in stock and cash to the holding company, which cost was approximately three times the book value of the subsidiary stock. This subsidiary had operated at a substantial loss during the period controlled by the holding company. In its consolidated balance sheet, the almost wholly-owned subsidiary was not consolidated, the effect being to show only a partially consolidated balance sheet in which intangibles were set out at $1.00 whereas a complete consolidation would have given effect to an intangible value of approximately 2½ million dollars. Furthermore, the consolidated balance sheet as presented developed an earned surplus of a quarter million dollars whereas a balance sheet consolidating the 97.12% owned subsidiary would have reflected a consolidated operating deficit of approximately $300,000. The Commission, working on the theory that item 56 of Form A-1 does not require a complete consolidation of all subsidiaries, even though it was obvious in this case that the effect of not consolidating both subsidiaries resulted in a misleading financial picture, was content with requiring footnotes to the financial statements setting forth an explanation of these various contradictory financial facts.

From these and other cases it is apparent that the Commission is willing to pass financial statements which may be deficient in setting forth accepted accounting practice provided the certifying accountant clearly points out the deficiency and states what the effect would be had more acceptable practice been followed. Its reasoning for this treatment results from the fact that it is administering a disclosure rather than a regulatory act and that a statement from the accountants concerning the accounting practice of the registrant gives a better picture of the managerial policy of the company than if the independent accountant were to revise the registrant's balance sheet and income statement to reflect more generally accepted accounting principles and practices.

To this accounting policy there are several notable exceptions. One of these concerned the practice of charging the cost of certain fixed assets and deferred expenditures to unrealized appreciation arising from write-up of gypsum deposits, the effect of which

was to relieve the earned surplus and profit and loss accounts of certain charges for depreciation on plant and equipment and other expenses. The certifying accountant upon having the erroneous accounting practice called to his attention agreed, at the suggestion of the Commission, to set up columnar balance sheets, one column showing the facts as per the company's books, the other balance sheet giving effect to a revised financial condition in accordance with accepted accounting practice.

Then there is the case of Standard Gas and Electric Company. The financial statements of this concern, when made a part of a registration statement under an E-1 filing, included some 63 pages of notes and comments subject to which the independent accountants certified these statements as being in accordance with accepted accounting practice. Even this liberal-accounting-minded Commission could not agree that an interested party must read a book in order to discover the real financial condition of its corporation. After several conferences between the Commission and its staff members, the registrant, and the accountant for the registrant, it was agreed that the effect of the relevant footnotes should be set out clearly on the face of the balance sheet and operating statements. The final result was again a set of columnar financial statements showing:

Amounts per Company's books	*Footnote Adjustments*	*Amounts if adjusted in accordance with footnotes*

Many practitioners feel, because of the pressure frequently placed on them by clients who may not have the professional accountant's high regard for what appears to be a fair and correct presentation of financial facts, that the solution, in such circumstances, is a columnar arrangement showing the financial statements as prepared by the company, set against the balance sheet and income statement as would be prepared by the independent accountant if he were left to his own devices.

CONCLUSION

In bringing this discussion to a close it is obvious that the SEC through the promulgation of accounting forms and accompanying instructions, and through its published and unpublished opinions and findings is having and will continue to have a foremost place in the standardizing of financial accounting practice. On the basis of its present approach this standardization is likely to be slow and evolutionary. However, as the Commission sees more and more questionable accounting principles reflected in financial statements filed with registration statements, there is a growing awareness of its part that the phrase "in accordance with accepted accounting principles" is a most indefinite characterization of what should be a fairly definite concept. Too frequently accepted accounting principles are simply those principles which each individual practitioner considers acceptable in the light of his own experiences and relations with his clients. What is needed is a critical study, by a disinterested group, of many of these principles and practices so that the practitioner and teacher alike may know what is or is not really acceptable by a majority of the better accountants. That this Commission will at some future time provide for an accounting research staff whose function it will be to define accepted accounting principles and practices and draw up standards of practice is not to be entirely unexpected. If this project is to be undertaken by a governmental body, I know of no such body more capable, more sincere or more impartial to do the job than the present Securities and Exchange Commission.

CAPITAL STOCK AND SURPLUS: LEGAL AND ACCOUNTING RELATIONS

HARVEY DEINZER

JOHN AUSTIN has well said, "The elements of a science are precisely the parts of it which are explained least easily. Terms that are the largest, and therefore the simplest of a series, are without equivalent expressions into which we can resolve them concisely. And when we endeavor to define them, or to translate them into terms which we suppose are better understood, we are forced upon tedious circumlocution."

PURPOSE AND SCOPE

The purpose of this article, concisely expressed, is to present capital stock and surplus relations. Relation can be taken either as expressing the affinity or dissimilarity of one thing to another, of one idea to another, as the word is commonly interpreted, or it may be taken to mean the expression or narration, the relating, of that which has been brought to one's notice, concerning the topic-matter. The second meaning is developed in the following pages.

Various contrasts, similarities, or affinities may obtain between things. A selection must be made. The writer has been interested primarily in the legal significance of these relations, and, secondarily, in the effect of the law, thus arrived at, upon accounting.

It has been said that the law is the best guess as to what the court will decide in a specific case.[1] It appears to be something in the nature of a sacrilege for a court to change the fundamental suppositions, and hence the conclusions of its predecessor. Aside from any question of right or wrong, it is a matter of empirical knowledge that a court bases its decisions very largely on precedent, or what preceding courts have decided in situations with pertinent facts similar. Acting on this premise, the writer has made frequent reference, in this discussion, to court cases, with the greatest concentration being made on Michigan cases.*

The terms capital stock and surplus are technical terms closely associated with corporations. Hence the boundaries of this article contain at least part of the subject-matter of corporations and do not extend beyond.

One further limitation of subject-matter may be mentioned. The treatment is very largely confined to mercantile and manufacturing corporations, operating as going concerns.

NATURE OF CAPITAL STOCK

Confusion of Meanings

Anything which furnishes waiting-power, and by so doing makes possible the more fruitful round-about production, is furnishing capital. In this sense capital cannot be a material thing; it must be a service. This is the capital of the economist.

The economist speaks of capital also as indicating those material instruments which are concretely used in the production of goods. In this sense capital may be factories, equipment, or other more or less material things used in production. Capital goods are the embodiment of the capital-furnishing service.

The accountant refers to the same capital goods, but he confines his concept to those goods used in a particular business enterprise. He includes money and merchandise and he calls these goods the assets of a company. This common use is recognized by the courts.[2]

Accountants in general agree about the meanings of the terms capital and capital

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[1] O. W. Holmes, "Collected Legal Papers," p. 173.

* Following an accepted practice, the writer has frequently designated Michigan cases by an oblique dash between the reference numbers, i.e., 247/418 means 247 Mich. 418.

[2] Smith vs. Dana, 60 Atl. 121; in re Wells' Estate, 156 Wis. 294; Armstrong vs. Emerson, 300 Ill. 54.

stock; but there is no uniformity of meaning by the courts of the several states. The property owned and used by the corporation in carrying on its business may be designated by the term capital stock. This was the terminology accepted by the highest California court in 1889. Capital stock may also refer to a specific fund of property.[3] The terms capital and capital stock are sometimes used synonymously or interchangeably.[4] That confusion exists is implied by the pains taken by some courts to create a distinction.[5]

The amount of capital stock which a corporation might have was limited by Act 232, P.A. 1903, to $25,000,000. This maximum limit was increased in 1917[6] to $50,000,000. In Dodge vs. Ford Motor Company[7] the plaintiff contended that the company's investment at that time, of over $100,000,000, "constituted an unlawful investment of the earnings" under the statute limitation. The question involved was whether the statute limited the net worth which might exist or applied only to the capital stock contribution in the first instance. If the former interpretation were correct there would be no distinction between capital stock and surplus.[8] The limit would be placed on the total equity of stockholders in the totality of corporate assets. The court took the alternative view. Ostrander, J., delivering the opinion of the court, said that the statute does not limit the surplus which a corporation may acquire through profitable operation nor to any increase in capital stock after the corporation has been operating. He held that the limit applies only to capital stock "contributed in the first instance," and he added, "It cannot be supposed that it (the legislature) looked with disfavor upon a profitable corporate existence."

The confusion goes even further. Capital stock is the term frequently used to refer to the certificates, drawn with ink upon paper, which represent the shares of stockholders in the corporation. The certificate is merely a symbol. To the symbol attach certain rights, which are really rights attaching to the shares for which the symbol stands. But the relator in Detroit Chamber of Commerce vs. Secretary of State[9] maintained that the capital stock certificates are property. This question was not necessary to a decision in the case, and the court did not discuss it. But a later court said that "when the increase of capital (stock) is ready for subscription and allotment, it is the property of the corporation, which is to be sold for the purpose of raising money . . . ,"[10] and again, "The capital stock in many cases is the chief asset of the corporation."[11] The last two cases do not present conclusive evidence that the court referred to the *certificates* as the property of the corporation; the second is clearer than the first. In the Continental Varnish case, the court, as was stated, called "the capital stock in many cases the chief asset of the corporation." In the next sentence the court continued, "The theory is that those dealing with it have the right to assume that this stock is all in the hands of bona fide subscribers. . . ." The phrase "in the hands of" may be figuratively used as referring to the intangible rights of stockholders. But the implication is at least present that the phrase refers to the tangible stock certificates. Even though this inference is mistaken, capital stock in the sense of prospective shares before the subscription and allot-

[3] See page 7.

[4] Penrose vs. Chaffraix, 106 La. 250; also, the New York statute prohibits the declaration of dividends which will impair the corporation's "capital or capital stock."

[5] In re Wells' Estate, supra; Shepard vs. State, 184 Wis. 88; Roberts and Schaefer Co. vs. Emmerson, 305 Ill. 348; Armstrong vs. Emmerson.

[6] Act No. 254, Public Acts 1917. Act 84, P.A. 1921 repeals this limitation. Kuhn, in his "Comparative Study of the Law of Corporations" said, "The amount of capitalization has no direct bearing on protection to stockholders or creditors, and the considerations in its favor would seem to be of a political rather than legal character.

[7] 204 Mich. 459.

[8] See also Lockhart vs. Van Alstyne 31 Mich. 76.

[9] 109 Mich. 691. In this case the relator applied for an increase in the authorized capital stock. The relator contended among other things that "they were authorized to hold property and that capital stock is property."

[10] Hammond vs. Edison Illuminating Company of Detroit, 131 Mich. 79. See also Shepard vs. State, 184 Wis. 88.

[11] Continental Varnish vs. Secretary of State, 128 Mich. 621.

ment of such shares can be the property or asset of the corporation in only a figurative sense, such as the right to levy taxes, or the assurance that funds can be raised through the levy of taxes, is the chief asset of the United States government.

That the concepts, and not the words, are the important elements is true, and it seems every man's right to designate a concept or thing with whatever name pleases him. This might have been the prerogative of Robinson Crusoe. But in a society, accuracy of expression is determined by reference to the people for whom the expression was intended.

Where one symbol is allowed to represent two concepts, confusion is very likely to result. Especially is this true where both concepts are merely different aspects of the same thing. If the court uses the term capital stock as meaning always the property contributed by stockholders, there will be no confusion in the mind of a person who is familiar with the court's usage. But where the court uses the term in two senses within the same paragraph there may be some difficulty of interpretation. In Brooks vs. Buys,[12] Wiest, J., said, "The capital stock of a corporation is the *property* of the corporation and constitutes a trust *fund* for the benefit of the corporation and its creditors. Creditors of the corporation have a right to rely, in extending credit, upon the public record of corporate organization therein of the amount of the capital stock *and the money or property paid in for stock*." Here a distinction is drawn between "capital stock" and "the money or property paid in for stock." In this second usage capital stock is something other than a property fund. Here it refers to the certificates which symbolize the equitable interests of stockholders in the corporate assets. This is reminiscent of Alice's experience in the Looking Glass world:

"When *I* use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."

[12] 217 Mich. 263.

"The question is," said Alice, "whether you *can* make words mean different things."

"The question is," said Humpty Dumpty, "which is to be master—that's all."

It is the writer's opinion that greater clarity will be attained by allowing one symbol to represent one concept so far as possible, in a particular field of knowledge.

Enough has been said to indicate the lack of uniformity in terminology and the confusion existing at times in the composite mind of the court as expressed through its decisions.

The Fund Theory

A view which courts have often taken, and one which the Michigan Supreme Court has always accepted, is that capital stock is property, and more specifically, a *fund* of property. This theory apparently is based on the common law doctrine of the rights of creditors. Creditors look to the assets of a business for satisfaction of their claims, which the courts support as having arisen from contracts. Proprietors are expected to contribute a portion of the assets, upon all of which the creditors have a first and satisfying claim. When the problem of corporations came before the court, it seemed natural that the court should regard the funds or other assets contributed by the proprietors, or stockholders, as the item upon which to concentrate its attention, when interpreting the statute.

That capital stock is (not represents, but *is*) property has been decided in numerous cases.[13] The decision in Dodge vs. Ford Motor Company was the first Michigan declaration of this definition, and it has frequently been referred to. The court there said, "The term capital stock, in its primary sense, means the fund, property, or other means contributed or agreed to be contributed by shareholders as the financial basis for the prosecution of the business of the corporation, being made directly through

[13] Lockhart vs. Van Alstyne, 31 Mich. 76; Dodge vs. Ford Motor Co., 204 Mich. 459; in re Joy's Estate, 247 Mich. 418; Wetherbee vs. Baker, 35 N. J. Eq. 501; Sohland vs. Baker, 141 Atl. 277; Amer. Refining Co. vs. Staples, 260 S. W. (Tex.) 614; Williams vs. Western Union Tel. Co., 93 N. Y. 162.

stock subscriptions or indirectly through the declaration of dividends."[14]

That capital stock was considered property was evident to the committee which drafted Section 31 of Act 232, Public Acts of 1903. This was more than fifteen years before the noteworthy decision in Dodge vs. Ford Motor Company. The section provides for the taxing of real and personal property held by a corporation in the state, and expressly excludes the capital stock of such corporation from this tax.[15]

It has been noted that the court refers to a property *fund*. The fund may consist of the property paid in by the stockholders to allow the execution of the purpose for which the corporation was organized. If we consider the "fund segregated" through the issue of stock dividends as being paid in, then this definition agrees with that advanced in the Ford Motor case. There the court considered the fund as being made directly through stock subscriptions or indirectly through stock dividends. A Delaware decision limits the fund to that raised by the issue and sale of its authorized capital stock.[16]

A second definition of the specific fund includes, together with assets received through stock subscriptions, "funds" earned by the corporation, and it excludes "funds" lost.[17]

A third definition of the fund is that of one specifically set aside by statute for the protection of creditors, which fund may be either more or less than the amount paid in by stockholders. In the case of a national bank, surplus had to be accumulated and associated with capital stock for the protection of depositors.[18] In this case, the statutory fund is larger than the amount contributed by stockholders. Some states by statute allow the directors of a corporation to determine that less than the amount of stockholders' contribution shall be segregated in a fund called capital stock.

The Michigan court continues to hold the view of capital stock as a fund.[19] The basis of this position is in the trust-fund theory of capital stock, which has been rejected by the courts of some states and also by the Federal Supreme Court.

Capital Stock as an Aspect of Property

The theory which is replacing that of capital stock as a property fund is that capital stock is an aspect of property, not the property itself. It may also be defined by saying that capital stock is an *amount* related to particular property. This is also the position taken by modern accountants. It is the essence of double-entry bookkeeping, as the writer has shown in another writing, excerpts from which will serve to clarify this concept:

"Single-entry bookkeeping attempts to record business facts such as the value of assets used in a business enterprise, the amount of claims due from customers and to trade creditors, the amount and source of borrowed capital. But no recognition is given to the absolute and proportionate rights of persons in the assets. Yet this phase is implicit in a single-entry system. This second aspect may be presumed to exist whether recorded or not. . . .

"The dual-aspect or multiple-aspect phenomenon is, as the term phenomenon indicates, a fact of experience. It is not essentially conceptual. The reader has probably experienced the effects of staring at a patterned linoleum for several minutes. The observer will note a succession of different patterns. The arrangement and positions of the lines and figures obviously have not changed. Here is an illustration of different ways of viewing the same thing.

"If the reader objects that the subjects of observation were not sufficiently concrete, let him consider the different ways in which a city made of stone and wood, iron and dirt may be physically viewed; for example,

[14] 204 Mich. 459.

[15] The section reads, in part, "Provided, Nothing herein contained shall authorize the taxing of the capital stock of such corporation as such capital stock."

[16] Sohland vs. Baker, 141 Atl. 277.

[17] Peoples vs. Commissioners, 23 N. Y. 192, 219; Williams vs. Western Union Telegraph Company, 93 N. Y. 162.

[18] The law has recently been changed to limit the stockholder's liability to the amount contributed, either paid-in or assessable, but the law does not hold as to banks in existence at the date of enactment.

[19] Stott vs. Orloff (1933) 261 Mich. 392.

through a window in a building, from the street, from a moving elevated car, from an airplane flying over the city. Each view gives a different picture, in each case a different side is displayed.

"It is not unnatural to deal with more than one aspect of a thing, as double-entry bookkeeping does. In fact many characteristics of the property and other assets used in a business are recorded, but not by the accountant. The accountant confines his interests to the value of the assets and to the 'therein-interests.'[20] The peculiar conditions of title, the cubic content of buildings, the goodwill factors contained in the pleasing appearance of the building arrangements may be matters of record but they are not part of the bookkeeping system."

And it is to the "therein-interests" or equities in the total of assets, by persons financially interested in the enterprise, that some courts have been giving their attention.[21] According to this view, capital stock may be defined as an equity or interest of stockholders in the totality of business property owned by a corporation. The economic values of assets are expressed in terms of money; from the sum of such money values is subtracted the total of liabilities; the resultant amount expresses the money value of stockholders' interest in the totality of assets. The value of this residuum may or may not be the amount of the capital stock.

In common usage, capital stock is only a part of the stockholders' equity in the total of asset values; the remaining interest is called surplus. The view that capital stock is the total stockholders' equity[22] or therein-interest, is primarily a creditor's viewpoint. It is the backlog upon which the creditors can rely for satisfaction of their claims. This seems also to be the ordinary business concept, taken from the outlook toward the partnership and single proprietorship enterprises. All of the partnership assets are subject to the claims of business creditors; the partners' interests are satisfied last, if at all. The preference given creditors' claims extends also to the field of corporations.

The position that capital stock is something less than the total therein-interest of the stockholders is analogous to one of the views noted in the discussion of capital stock as a property fund. Among accountants, capital stock is very commonly regarded as the amount of therein-interest of stockholders which is equal to the amount of property contributed by stockholders, either directly through stock subscriptions or indirectly through stock dividends.

Here too, just as in the treatment of the property fund, there is found a third meaning of capital stock, differing only in latitude or comprehensiveness from the two preceding variations. It is the amount of the stockholders' therein-interest which the statute provides, either explicitly by its terms or by option of the board of directors, shall be treated as distinct from the remainder of the therein-interest.

Comparison of the Two Views

The terminology employed in the Michigan and Delaware corporation statutes, and in similar statutes of other states, as well as in court decisions, seems to be based on the presupposition that certain funds of assets can be segregated and labeled. The court looks at a corporation as a creature of the state, endowed with powers, and simulating a person. The corporation begins existence with stock certificates, which it "sells." The money or property received for the stock, even patents, are more or less tangible. The stockholders' rights *in the first instance* attach to a fund which can be thought of quite clearly and concretely.

And in general, on a background of the ownership theory, it is natural to think of rights as inhering in specific assets. For example, person or group A's rights attach to asset I, and person or group E's rights

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[20] Called by Paton (*Accounting Theory*) "equities," and by Cole (*Fundamentals of Accounting*) "ownership-claims."

[21] In re Wells' Estate, 156 Wis. 294; Roberts & Schaefer Company vs. Emmerson, 305 Ill. 348; Armstrong vs. Emmerson, 300 Ill. 54.

[22] Sometimes termed "net assets." But it is better to reserve the term "net assets" to mean book values of assets less allowances such as reserves for bad debts or depreciation. Also, the emphasis would be on the property rather than on equities.

attach to asset V. This assertion is made on the principle of analysis; the mass is broken down into an orderly scheme. The result is opposed to the state in which the elements are not perceived, which state would be jarring to the analytical mind of the court. There must be analysis, classification—simplification. "Capital stock is a fund"—the mass of corporate property is assailed in spirit and it is determined that the rights of stockholders expressed as capital stock inhere in a specific portion of the corporate property. An impetus toward this outlook was given by the desire to conform to the necessity of recognizing certain practical legal and business considerations with regard to capital stock, liabilities, and surplus.

But the "tangibles" view is not necessary to an adequate recognition and disposition of these legal and business necessities. The facts of owning and using property; the fact of owing money; the relations between corporation and creditors, and corporation and stockholders; the provisions of the statute with regard to capital stock and surplus can be dealt with at least as efficiently, and certainly with greater dispatch by defining capital stock as a simple financial and legal aspect of the corporate situation, rather than as a fund of property, constantly changing in make-up but remaining constant in amount.

It is clear that in the business life there is a continuous process of metabolism. Products are being fed into the circulatory system, carried to the organs or departments in close relation to the outside world, and eliminated. New material is taken into the body, its character changed to conform to the body's needs, and either utilized immediately or stored for future call. Replacements are made to the body to compensate for exhausted and worn-out parts, and if the conditions of living have not been too severe, and if the body has functioned properly, there will probably be some growth. The man of fifty looks very much like the boy of eighteen; he has, roughly, the same physical characteristics. But physiologically he is not the same. The protoplasm has been undergoing continuous change; there has been a building up and a breaking down, an assimilation and an elimination.

In the business enterprise there is an analogous change. There is a continual intermingling of assets, making identification of the source impossible. The capital, or property, of the corporation is constantly turning over, the merchandise and other working capital very rapidly, the fixed capital, or capital assets, more slowly, yet just as surely. If the business is unsuccessful, there is no growth; instead there is a loss of capital. If the body does not receive and assimilate at least as much food as is broken down in the body, in equivalent, there is a wasting away. Hence it is the favored man, just as it is the successful corporation, that is under consideration.

The fund theory is untenable, not only because of the continuous process of metabolism with relation to the assets, but also because of a significant inconsistency in the theory. The money amount, or value, of corporate property is constantly changing. Even the amount of a theoretically segregated fund changes. Capital stock, on the other hand, does not fluctuate; it cannot be reduced by other than formal state-authorized action, according to the present Michigan statute.

The denial of the right of the corporation to reduce its capital stock except by express authorization from the state did not apply to a reduction in the number of shares, it was held in a Michigan case. The stockholders had voted to reduce the number of shares while leaving the amount of capital stock unchanged. It was held that the secretary of the state was compelled to file a notice of the action and, by so doing, assent to it.

It has been seen that the view that capital stock is a fund is untenable, both because of the intermingling and turning over of assets and because of the unfluctuating character of capital stock. The view that capital stock is an aspect of the totality of assets, being a stated equity of stockholders in that totality, is theoretically more tenable and practically more accurate. The argument must necessarily apply to surplus as well as to capital stock because of the homogeneity of their characters. The difference is not one of equity or ownership but rather one of statutory privilege or restriction. In any fluctua-

tion of stockholders' equity, resulting naturally from the fact of its being a residuum, the surplus is said to be affected first, and capital stock is assumed not to change until the stockholders' therein-interest falls below the stated amount of capital stock. A preference is imposed upon the situation, both by law and by business expediency.

If the reader will keep in mind the closeness of communion between capital stock and surplus, a brief treatment of surplus will suffice to make clear its nature.

NATURE OF SURPLUS

The Michigan Supreme Court defines surplus as a fund of assets. The latest pertinent decision contains this view.[23] The courts of some states have abandoned this position in favor of surplus as an aspect of the totality of corporate assets.[24]

Accountants in general, and the courts in particular, recognize four classes of surplus: paid-in surplus, donated surplus, earned surplus, and surplus from a higher valuation of assets. Each surplus recognizes a relative increase in asset values.[25] Both statutory and common laws place different preferences and restrictions upon the several types of surplus, consistent with the character of the relative increase in the values of assets.

Earned surplus in general represents accumulated profits. It is interesting to note that the early rule in Michigan considered undistributed profits as forming a part of capital stock.[26] Later Michigan courts looked at undistributed profits as being distinct from capital stock and as constituting earned surplus. By 1919 this rule was well established. The equity rule that a court may require a corporation, in particular circumstances to distribute a part of its surplus to stockholders is an emphatic admission that accumulated profits have been emancipated from the capital stock atmosphere.

The legal character of surplus will be examined more fully in the section treating of dividends.

DIVIDENDS: DISTRIBUTION OF SURPLUS OR CAPITAL STOCK

The Nature of a Dividend

In Lockhart vs. Van Alstyne[27] the plaintiff was guaranteed dividends on its preferred stock. The plaintiff argued that the word "dividend" meant only something to be divided.[28] The court distinguished between an operating concern and one in liquidation and said that with reference to the former a dividend is "a fund which the corporation sets apart from its profits to be divided among its members."[29] The court meant current profits, since profits not distributed became part of capital stock.[30] And since dividends could not be declared from capital stock, it follows logically that dividends could not be declared in any year when the company had no earnings even though past undistributed profits had been large. Cooley, J., giving the opinion of the court, said, "A corporation of which it is said that it is making an annual dividend of 10%, is supposed to be a prosperous corporation, because its gains leave it this clear annual percentage, which it can pay over *without impairing its capital.*" This sentence, when read alone, is not conclusive evidence that it is not deemed allowable for a corporation to declare dividends from past profits. But in a subsequent sentence the court said, speaking of preferred stock which the court considered cumulative, that "probably if profits were not realized to the proper amount in any one year, they would be entitled, *when they were realized*, to have all arrears made up." In this case the preferred stock was issued with the provision that the semi-annual dividend of 5% was guaranteed. The court construed this provision to mean

[23] Stott vs. Orloff (1933), 261 Mich. 302. See also in re Joy's Estate, 247 Mich. 420.

[24] The word "surplus" is sometimes used in its common meaning, as anything left over after preferential deductions. Detroit Trust Company vs. Detroit City Service Co., 262 Mich. 14; Sect. 11, Act 232, P.A. 1931, with regard to liquidation of corporate assets.

[25] Liabilities and capital stock remaining unchanged.

[26] Lockhart vs. Van Alstyne, 31 Mich. 76.

[27] 31 Mich. 76.

[28] On basis of fund theory; really a division.

[29] See also Mobile & Ohio R. R. vs. Tennessee, 153 U. S. 486, 496.

[30] See above.

that the dividend was guaranteed to be paid if and when there were current earnings. The court could have held that past earnings should be applied in payment of the dividend, but it held, on the contrary, that undistributed past profits became a part of capital stock, and that a distribution thereof would impair the capital stock. Such an impairment of capital stock was by law forbidden.

The "current profit" rule was changed to allow dividends to be declared from accumulated profits, or earned surplus. By the time of the Dodge vs. Ford Motor Company case this rule was well established in Michigan. The rule had been changed in other states as well.[31]

A dividend, then, is a declaration, by the board of directors, of a separation from profits. Dividends declared are a claim of the stockholders as individuals against the assets of the corporation. The equity of net worth becomes a liability claim.

The rule arose in equity that even though the stockholders have no claim for dividends until the board of directors declares a separation from surplus, the court, upon appeal by minority stockholders, may order the corporation, through its directorate, to make a distribution of its surplus as dividends. The court will exert this power only if there has been a breach of good faith with the stockholders by the board of directors.[32]

A dividend is a division of profits. The converse is also true. A division of profits is a dividend, even though the directors or stockholders do not consider it so.[33]

Kinds of "Dividends"

The term "dividend" in the statute, and in its accepted meaning by the courts, refers to a division of profits past or present. Of course, the term also refers to the cash or other property distributed. But it does not, in its statutory meaning, refer to the conversion of corporate assets into cash and their distribution among the stockholders in the process of liquidation.[34] Such a distribution is ordinarily styled "liquidating dividend."

A dividend in property, or a dividend "in kind" has no legal difference from an ordinary cash dividend. The "dividend" refers properly to the declaration, by the directorate, of a liability-claim in place of the surplus-claim. Distribution of property in satisfaction of the dividend-claim is only incidental.

The term "stock dividend" is a misnomer. True, the stockholders receive stock, and they do so through a pro-rata distribution. But the corporation parts with no property; and the stockholders as a class have no smaller therein-interest, or equity in the totality of assets, than they had before the stock "dividend" was declared. The change in the nature of the equity is a shift from a surplus-claim, with particular legal rights and restrictions, to a capital-stock-claim, having somewhat different legal and business significance. The issue of stock is not essential to a transfer of surplus to capital stock; the Michigan statute[35] allows the directorate to make a simple transfer of paid-in surplus to capital stock.

Although in common law a dividend could be declared only from net profits or from earned surplus, the statute allows dividends on preferred stock to be declared from *any* surplus (Section 22). Probably, appreciation surplus could be used as a basis for preferred dividends.

Illegality of Paying Dividends in Impairment of Capital Stock

The Michigan statute prohibits the payment of dividends if such payment "impairs" the capital stock.[36] The statutory objection is merely a formal expression of

[31] Colorado ex rel. Fraser vs. Great Western Sugar Company (1928) 29 F(2d) 810; Council vs. Brown (1921) 151 Ga. 564; Mente vs. Groff (1910) 10 Ohio N. P. N. S. 148.

[32] Knight vs. Alamo Mfg. Co. 190 Mich. 223; Dodge vs. Ford Motor Co. 204 Mich. 459; in re Joy's Estate 247 Mich. 418; Morehead Mfg. Co. vs. Washtenaw Circuit Judge 254 Mich. 697; Hunter vs. Roberts Throp & Co. 83 Mich. 63; City Bank Farmers' Trust Co. vs. Hewitt Realty Co. 257 N. Y. 62.

[33] Barnes vs. Spencer Barnes Company, 162 Mich. 509; Hadley vs. Commissioner of Internal Revenue, 59 App. D. C. 129.

[34] Bay City Bank vs. St. Louis Motor Sales, 255 Mich. 261.

[35] Act No. 232, P. A. 1931.

[36] Does not apply to "wasting asset corporation."

the common law doctrine. In the case of a private enterprise or partnership, the creditor enjoyed certain rights which included reparation for loss resulting from reliance on the expressed net worth of the owner or partners in the business, when the actual net worth was really less than that expressed.

This rule as related to corporations was expressed by Hooker, C. J., in American Steel Wire Company vs. Eddy,[37] "When a corporation holds itself out to the world as possessed of a given capital (stock), those who deal with it have a right to the application of such capital to the payment of such debts as it may incur, and it has no authority to impair its capital by refunding to the stockholders a portion of its capital by way of dividend." Express statutory authority must be given to over-rule the common law, and the statute gives the corporation no such authority in this matter. Indeed, it is probable that the courts would over-rule any statutory permission to declare dividends from capital stock before all debts are paid, as against public policy.

The statute makes directors liable to the corporation for the amount of dividends paid in impairment of capital (stock).[38] Directors are personally liable to the corporation. In a New York case it was held that the burden of proof is on the plaintiff.[39] But where proper care was not taken, an English case held that the burden of proof was with the directors.[40]

Stockholders are also liable to the corporation, *and to creditors*, for repayment of funds received as dividends in impairment of capital stock. This is not a personal liability, as in the case of directors. Rather, the stockholders are liable as recipients of a trust fund.[41] This view has the old trust-fund theory as a background. Creditors who have exhausted their rights against the corporation can sue the stockholders jointly and severally.[42] But it has been held not necessary first to exhaust the liability against the corporation before suing the stockholders.[43] The good faith of the corporation in paying such dividends is no defense in an action for their recovery.[44] Any one class of stockholders who were thereby injured could compel the corporation to recover the funds paid in impairment of capital stock.[45] This remedy, although having a basis in common law, was expressly given by statute.[46]

When does a dividend impair capital stock? If the actual capital stock is less than that required by statute, can dividends be declared from net earnings before such impairment is made up? In England a distinction is drawn between fixed and circulating *capital;* a depreciation in the latter, but not in the former, must be made up before dividends may be declared.[47]

In Michigan, the general rule prevails that any loss in the capital stock must be replaced before dividends can be paid, even in the presence of current earnings. The court would probably hold to this doctrine in spite of the statutory right to declare dividends from surplus *or from net earnings.* The trust-fund theory assumes that the rights of creditors are paramount to the rights of stockholders.

The burden of proof is upon those who attempt to show that a dividend does impair capital stock. All dividends are pre-

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[37] 130 Mich. 266. See also Alfred J. Brown Seed Company vs. Brown, 240 Mich. 569, and Lockhart vs. Van Alstyne, 31 Mich. 76; also, Richardson vs. Buhl, 77 Mich. 632, 649.

[38] Act 327, P. A. 1931, sec. 48.

[39] Excelsior Petroleum Company vs. Lacy (1875) N. Y. 422.

[40] Leeds Estate Bldg. & Invest. Co. vs. Shepherd (1887) L. R. 36 Ch. Div. (Eng.) 787.

[41] American Steel & Wire Company vs. Eddy, 130 Mich. 266.

[42] McIntyre vs. E. Bement's Sons, 146 Mich. 74; Detroit Trust Company vs. Goodrich, 175 Mich. 168; Brooks vs. Buys, 217 Mich. 263; Clark vs. E. C. Clark Machine Company, 151 Mich. 416; American Steel & Wire vs. Eddy, 130 Mich. 266. In Clark vs. E. C. Clark Machine Company it was held that even subsequent creditors could recover a payment to stockholders in impairment of capital.

[43] First National Bank vs. A. Heller Sawdust, 240 Mich. 688.

[44] American Steel & Wire Company vs. Eddy, 130 Mich. 266; Detroit Trust Company vs. Goodrich, 175 Mich. 168.

[45] Detroit Trust Company vs. Goodrich, 175 Mich. 168.

[46] Section 7057, Comp. Laws 1897.

[47] Verner vs. General & C. Investment Trust (1894) 2 Ch. 239; Bond vs. Barrow Haematite Steel Co. (1902) 1 Ch. 353.

sumed to be from income.[48] If at the time a dividend is declared capital stock is not impaired, subsequent losses which impair the capital stock do not cause the dividend to be unlawful.

DECREASE IN SURPLUS: RELATION TO CAPITAL STOCK

Surplus may be decreased through losses and, as noted in the preceding section, by the declaration of dividends. It may also be decreased through the issue of stock dividends and by repurchase of the company's capital stock.

Stock Dividends

A stock dividend ordinarily is distinguished by two features, first, an issue of stock to the stockholders in proportion to their holdings and second, a reduction in surplus combined with a corresponding increase in capital stock.

Concerning the legitimacy of a stock dividend, the court made an excellent statement in Williams vs. Western Union Telegraph Company,[49] "If it (the corporation) can issue stock in payment of property to be obtained by it as part of its capital for its legitimate uses, why may it not issue stock in payment for property in effect purchased of them and added to its permanent capital and which they relinquish the right to have divided? So long as every dollar of stock issued by the corporation is represented by a dollar of property, no harm can result to individuals or the public from distributing the stock to stockholders."

Whether a stock dividend or an unusual cash dividend belongs to the income or corpus of a life estate with succession to a remainderman is a question which the courts have had difficulty in deciding. Three rules have been evolved, all of which are affected by the distinction between capital stock and surplus. The Kentucky rule awards all dividends to income.[50] The Massachusetts rule regards all cash dividends as income and stock dividends as belonging to the corpus of an estate.[51] The Pennsylvania rule considers the time when the surplus was earned.[52] If the surplus divided was earned before the beginning of the life estate, the dividend is corpus and belongs to the remainderman; if after the beginning, it is income and goes to the beneficiary.

Hence under the Pennsylvania rule particularly, and under the other rules also, it is necessary to know that a dividend is from surplus and does not impair the capital stock. Although the Kentucky rule awards all distributions to income, certainly a dividend in impairment of the capital stock would not be considered income, but rather a liquidation of the corpus.

Also, under the third rule, if the court holds that a dividend shall not be allowed from net earnings when the capital stock is impaired, the earnings which make up this deficit will go to increase the value of the corpus, and it will be impossible ever to declare these earnings as dividends even though they were earned during the period of the life estate.

Purchase of Corporate Stock

The corporation statute prior to 1929 gave the corporation no express power to buy its capital stock. But neither was the power denied. In spite of the doctrine that a corporation possesses only such powers as are specifically granted to it by its charter, or as are incidental thereto,[53] the courts have held that a solvent corporation may purchase its own stock in the absence of express provisions to the contrary.[54] An insolvent corporation cannot purchase shares of its stock because such action would injure the rights of creditors.[55] The decision in Mc-

[48] Soehnlein vs. Soehnlein, 146 Wis. 330; Miller vs. Payne, 150 Wis. 354.
[49] 93 N. Y. 190.
[50] Cox vs. Gaulbert's Trustee, 148 Ky. 407.
[51] Minot vs. Paine, 99 Mass. 101.
[52] Smith's Estate, 140 Pa. 344.
[53] Orr vs. Lacey, 2 Doug. 253.
[54] McIntyre vs. E. Bement's Sons 146 Mich. 74; Reith vs. University Housing Corporation, 247 Mich. 104; Stott vs. Orloff, 261 Mich. 302; Cole vs. Cole Realty Co., 169 Mich. 347; New England Trust Co. vs. Abbott, 162 Mass. 148; Barrett vs. King, 181 Mass. 476; Silversmiths Company vs. Reed & B. Corp., 199 Mass. 371; Brown vs. Little, Brown & Company, 168 N. E. (Mass.) 521.
[55] Reith vs. University Housing Corporation, 247 Mich. 104; Stott vs. Orloff, 261 Mich. 302.

Intyre vs. E. Bement's Sons,[56] to the effect that a solvent corporation can purchase its stock, was questioned by the respondent in Lufkin Rule Company vs. Secretary of State.[57] He argued that "a corporation organized under Act No. 232 has no right to purchase its own shares." The court did not determine the question in this case. The question was not again raised until Barden vs. A. Heller Sawdust Company,[58] in which case the court decided that a solvent corporation might purchase its own stock, "at least when done from surplus," while an insolvent corporation could not do so because against public policy.

The phrase "at least when done from surplus" is significant. Act No. 267, Public Acts of 1929, gives the first express privilege to the corporation to buy its own stock, and Act 327, P. A. 1931 allows the corporation to purchase its stock *only from surplus*.[59] An exception is made in the case of redeemable preferred shares, which can be retired against capital stock.

Prior to the 1929 act, the statute allowed a corporation to increase *or decrease* its capital stock by a vote of $\frac{2}{3}$ of the shares of the corporation. The secretary of state was compelled to allow such reduction upon proper filing, with him, of notice of such action. Under the present statute, any contemplated reduction in the capital stock of a corporation must be authorized by a state board to become effective. Consequently any increase in capital stock through a transfer from surplus (as in the case of a stock dividend, or directly from paid-in surplus) can not readily be reversed. Besides the right to redeem preferred stock under contract, the only other method allowed the corporation to reduce its capital stock is the privilege of purchasing its shares *from surplus*.

If preferred shares are redeemed, capital stock can be reduced to the extent that the consideration therefor was declared by the board of directors to be the amount of capital stock. Such stock when redeemed has the character of unissued and authorized shares. Stock can be resold only when purchased "from surplus." What constitutes a purchase from surplus will be considered shortly. Redeemable preferred stock if bought before the redemption date must be bought from surplus; but at the redemption date an appropriate amount can be transferred from capital stock to surplus.

The section[60] of the statute relating to the redemption of preferred shares is somewhat ambiguous. The words seem to imply that purchases, as distinguished from redemption, may be made against capital stock if the remaining assets are "sufficient to pay any debts of the corporation." The words "redeemed" and "purchased" seem to be used interchangeably here; yet a distinction is drawn between them elsewhere in the section. Shares shall be *purchased* from surplus; they shall be *redeemed* against capital stock. Stock *purchased* can be resold at any price fixed by the board of directors; stock *redeemed* can be reissued only at a price that would be legal for shares originally issued.

It is clear that the statute distinguishes between preferred shares at the redemption date and all other shares including redeemable preferred shares before the redemption date. The latter class of stock, "all other," can be purchased only if such action does not impair the capital (stock)[61] of the corporation (Section 10), and such purchase is to be made from surplus (Section 37). What is the significance of this provision?

It appears that this provision of the statute may modify the practice adopted by accountants in interpreting the purchase of stock by the corporation, logically consistent though the practice is.

[56] 146 Mich. 74.

[57] 163 Mich. 30.

[58] 240 Mich. 549. The court again expressed the rule in Reith vs. University Housing Corporation, 247 Mich. 104.

[59] Section 37. Section 10 of this act (compiled laws of 1934) allows this privilege if such action does not impair the capital (stock) of the corporation.

[60] Sec. 37, Act 327, P. A. 1931.

[61] Act No. 327, Public Acts 1931, of which section 10 reads, in part, "Provided, That no corporation shall use its funds or property for the purchase of its own shares of capital stock when such use would cause any impairment of the capital of the corporation." In Stott vs. Orloff, 261 Mich. 305, the court interpreted "impairment of capital" as a turning out of income-producing assets "outside of surplus and profits" in payment for such stock.

The accountant, naturally enough, views the purchase of a share of stock as a reduction in the number of shares of capital stock and also as a reduction in the total capital stock. Assets have been reduced by the price of the share of stock; and the value of the stockholders' interest in the corporate assets has likewise been reduced. In effect, the contribution of a stockholder to the enterprise has been refunded.

The statute, however, provides that the purchase of stock shall be made from surplus. How will the court interpret this restriction? The court has clung to the early view that the word "surplus" means the actual assets that have been accumulated through years of successful operation or those, other than capital stock, which were contributed by stockholders, or the addition of increased asset *values*. Since the surplus is constituted by a portion of assets, the purchase of stock from a fund of assets known as surplus will necessarily decrease surplus, just as pouring water from a glass will lower the water in the glass, not in the nearby bucket. And it is the court's interpretation of the statute, not the statute itself, which is enacted law.

Likewise, the court views capital stock as a trust fund for the benefit of creditors. Although the number of shares of stock which a corporation may have outstanding can be reduced at will, the capital stock cannot be decreased except by state authorization. This is a fundamental doctrine of the Michigan court and will probably overrule any legislative enactment which seeks to set it aside or modify it. The capital stock shall not be impaired; the fund shall be kept intact. If assets are paid out in the purchase of stock they must come from some other fund; they cannot come from the capital stock fund. The purchase must be made from surplus.[62]

The court's interpretation will have considerable balance-sheet significance. The accountant is loathe to forsake his logic. He insists that the phrase "from surplus" means "to the extent that there is surplus." The reduction is made against capital stock, and is limited by the amount of surplus. Surplus is not reduced; it merely expresses a limit.

It may be that the court will construe a corporation's accounts as a convenient method of recording facts and will allow a method which, while not strictly in accord with the interpretation of the courts, does accomplish the same result, preservation of the capital stock "fund." It may be that the corporation will be allowed to reduce the capital stock account upon purchase of its shares if, at the same time, the corporation recognizes in its accounts that a corresponding amount of surplus must be maintained. When the stock is resold, an amount of surplus equal to the second consideration will be freed. The balance sheet will show:

Capital stock, issued at 110	$100,000	
$10 per share declared to be surplus		
Less, Stock purchased at par (200 shs.)	20,000	$ 80,000
Surplus,		
Paid-in surplus, $10 per sh.	$ 10,000	
Appreciation surplus	25,000	
Earned surplus	12,000	
Total	$ 47,000	
Surplus appropriated to purchase stock	$ 20,000	
Free surplus	27,000	
Total surplus		47,000
Total net worth		$127,000

For elucidation to the board of directors, a schedule should accompany the balance sheet, the schedule being somewhat as follows:

The surplus first to be appropriated for the purchase of stock is the sum of paid-in and appreciation surplus. Earned surplus shall last be appropriated for this purpose because of the possibility of declaring common dividends from earned surplus and from none other:

Paid-in surplus	$10,000	
Appreciation surplus	25,000	$35,000
Less, Surplus appropriated to purchase stock		20,000
Surplus which, together with earned surplus, is available for preferred dividends		$15,000
Earned surplus, available for common dividends		12,000
Free surplus		$27,000

[62] Lewis, in his article published in *Accounting Review*, June, 1933, suggests the possible alternative of treating repurchased stock as treasury stock, i.e., carrying it as an asset. He admits that this is probably not the intent of the statute, even though he finds no express prohibition in the Michigan statute against carrying it as an asset.

A balance-sheet treatment in accord with the court's probable interpretation of the statutory provision that shares shall be purchased from surplus will show the amount paid for such stock as a direct deduction from surplus. Since the court defines surplus with reference to "net assets,"[63] it seems logical to consider appreciation surplus as available for the purchase of stock. It is in the corporation's interest, and no doubt legally permissible[64] to deduct the amount paid for purchased stock first from the sum of paid-in and appreciation surplus, leaving earned surplus available for common dividends as long as there remains appreciation or paid-in surplus. The most important argument against the first treatment is that formal state-authorized action is necessary to reduce the capital stock, and hence a treatment showing a reduction in capital stock is not in accord with the facts. The solution rests on the view adopted as to the purpose of accounts. The first treatment assumes that it is the function of accounts to record business facts *from the viewpoint* of the proprietors or stockholders, and that this approach must be modified in accord with the legal situation. But it refuses the position that the legal viewpoint determines. It is the writer's opinion that the weight of argument, both practical and logical, is with the proprietary viewpoint, rather than the legal, in determining the accounting treatment.

[63] The court's designation of the difference between the total of assets and the amount of liabilities. From this difference the amount of capital stock is deducted to determine the amount of surplus.

[64] Although possibly not ethically justifiable, it is possible to use funds in excess of par value, paid in by preferred stockholders, to buy stock, preferred or common, from favored shareholders.

STATE TAXATION OF CORPORATE INCOME

HARRY L. KUNZE

"THE payment of taxes is an obvious and insistent duty."[1] It must be equally obvious that with increasing governmental activities there will be an increase in the tax burden. Legislative bodies in their efforts to balance budgets, will have to look to all available sources for revenue. It is to be expected that they will rely more and more upon the income tax which has proved so successful in a large and rapidly increasing number of states.

There are special problems involved in the taxation of incomes by states which are not encountered in the Federal income tax. One of these is the allocation of income from business crossing state lines to the different states having an interest in that business for taxing purposes. In an address by Ogden Mills, Secretary of the Treasury, before the Association of the Bar of the City of New York in April 29, 1932, it was stated that this was perhaps the most important problem involved in the use of an income tax by the states. This thesis deals in the main with the question of apportioning the net income of manufacturing corporations among various states having claims to it. It is impossible, however, to get a proper understanding of this question without constantly keeping in mind the constitutional limitations on the taxing powers of the states. Moreover, the tax on net incomes is a new and undeveloped tax as compared to property, excise and other taxes. The law is not settled on all points and it is frequently necessary to review the decisions on other forms of taxation in order to have some idea of what might take place in the income tax field.

The Federal Constitution restricts in several ways the right of a state to tax. Sec. 10 of Art. 1 provides that "no State shall, without the consent of Congress, lay any imports or duties on imports or exports, except what may be absolutely necessary for executing the inspection laws." There is an implied limitation that no state shall tax the instrumentalities of the Federal Government. The Fourteenth Amendment states "nor shall any State deprive any person of

[1] Bankers Trust Co. vs. Blodgett, 260 U.S. 647, 651, 43 Sup. Ct. 233, 67 L. Ed. 439, 442 (1923).

life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." One more important provision remains—the last listed here but by no means the least in its effect upon our problem—Clause 3 of Sec. 8 of Art. 1 gives to Congress the power to regulate commerce among the several states.

STATE TAXATION AND THE COMMERCE CLAUSE

Although this clause does not contain any express statement about taxes, it has played a most important part in tax decisions. The theory has been that any state tax which amounts to a direct burden on interstate commerce is an interference with a power granted to Congress and therefore beyond the power of the state. This has been well stated as follows:

> By the Constitution (article 1, section 8, clause 3) the power to regulate interstate commerce is expressly committed to Congress and therefore impliedly forbidden to the States. The purpose in this is to protect commercial intercourse from invidious restraints, to prevent interference through conflicting or hostile state laws and to insure uniformity in regulation. It means that in the matter of interstate commerce we are a single nation—one and the same people. All the states have assented to it, all are alike bound by it, and all are equally protected by it. Even their power to lay and collect taxes, comprehensive and necessary as that power is, cannot be exerted in a way which involves a discrimination against such commerce.[2]

It was early seen that if states could tax interstate commerce without limit they could stop such commerce at state lines and there would be nothing left for Federal regulation. This principle does not prevent a state from taxing the property of companies engaged in interstate commerce.[3] And the property may be valued on the basis of a going concern.[4]

In Adams Express Co. vs. Ohio,[5] state officials were permitted to use a valuation far in excess of the value of the companies' horses, wagons, and furniture considered as separate and distinct objects. Income was thus indirectly taxed in that earning capacity established the value of the system as a whole. As to a state tax on gross receipts from interstate commerce, the general rule is that the tax is unconstitutional.[6] In Crew Levick Co. vs. Pennsylvania[7] a tax was declared void as a regulation of interstate commerce and a duty on exports where it was levied upon the business of selling merchandise in such commerce and was measured by a percentage of the gross transactions. It was held to be a direct burden since the state took a part of each dollar received, and the fact that internal transactions were taxed in the same way did not save it. These cases illustrate the shortcomings of sales taxes imposed by states.

State excise taxes are closely examined by the Supreme Court and the statutes imposing them must be carefully drawn if they are to be sustained. Apparently there is no limit on the power of a state to lay this type of tax on its own corporations irrespective of where their business is done. This was the holding in Cream of Wheat Co. vs. County of Grand Forks[8] as the plaintiff in that case had incorporated under the laws of North Dakota but all of its business and property was wholly outside that state. The State Supreme Court construed the tax as one upon the privilege of being a corporation and the United States Supreme Court held it to be valid.

The situation is much different where a corporation doing business in one state has been created in another state. In Interstate Transit Inc. vs. Lindsey,[9] Tennessee unsuccessfully attempted to tax an Ohio Corporation for the privilege of doing an interstate bus business. Missouri was prevented,

[2] Pennsylvania vs. West Virginia, 262 U. S. 553, 596, 43 Sup. Ct. 658, 67 L. Ed. 1117 (1923).

[3] Pullman's Palace Car Co. vs. Pennsylvania, 141 U. S. 18, 11 Sup. Ct. 876, 35 L. Ed. 613 (1891).

[4] Galveston, H. & S. A. Ry. Co. vs. Texas, 210 U. S. 217, 28 Sup. Ct. 638, 52 L. Ed. 1031 (1908).

[5] 165 U. S. 194, 17 Sup. Ct. 305, 41 L. Ed. 683 (1897).

[6] Phila. Steamship Co. vs. Pennsylvania, 122 U. S. 326, 7 Sup. Ct. 1118, 30 L. Ed. 1200 (1887).

[7] 245 U. S. 292, 38 Sup. Ct. 126, 62 L. Ed. 295 (1917).

[8] 253 U. S. 325, 40 Sup. Ct. 558, 64 L. Ed. 931 (1920).

[9] 283 U. S. 183, 51 Sup. Ct. 380, 75 L. Ed. 953 (1931).

in Ozark Pipe Line Corp. vs. Monier,[10] from collecting an annual franchise tax even though it was measured by only that part of the capital stock and surplus employed in the state. The company transported crude petroleum by pipe line and the court treated its business as exclusively interstate. It is not clear how far a state may go in taxing a foreign corporation that carries on a local business along with interstate transactions. The court in Baltic Mining Co. vs. Mass.[11] ruled as constitutional an annual excise tax on the authorized capital stock of a Michigan corporation where the tax was not to exceed in any one year the sum of $2,000. Just what part, if any, of this decision is still law is doubtful in view of the following language used in Alpha Portland Cement vs. Mass.[12]

> It must now be regarded as settled that a state may not burden interstate commerce or tax property beyond her borders under the guise of regulating or taxing intrastate business. So to burden interstate commerce is prohibited by the commerce clause; and the Fourteenth Amendment does not permit taxation of property beyond the state's jurisdiction. The amount demanded is unimportant when there is no legitimate basis for the tax. So far as the language of Baltic Mining Co. vs. Massachusetts, 231 U. S. 68, 87 (34 S. Ct. 15, 58 L. Ed. 127) tends to support a different view it conflicts with conclusions reached in later opinions and is now definitely disapproved.

It should be added that while it is a general rule that a state may prescribe such conditions as it chooses in permitting a foreign corporation to come into the state to engage in ordinary business, this rule does not apply to a corporation transacting interstate business. Western Union Telegraph Co. vs. Kansas[13] and decisions following it are authority for the principle that a corporation engaged in domestic and interstate business may continue to do business unaffected by state imposed conditions which violate constitutional rights.

This brief summary of the law on excise taxes has been presented because of the close relationship of this type of tax to the income tax. The validity of a general state income tax on the profits arising out of interstate commerce was established in the important case of United States Glue Co. vs. Oak Creek.[14] The corporation was organized in Wisconsin and operated an extensive manufacturing plant there, selling its goods in that state, in other states and foreign countries. In holding that the Wisconsin income tax law was not so direct a burden as to constitute a regulation of the interstate business of the plaintiff the court said:

> The difference in effect between a tax measured by gross receipts and one measured by net income, recognized by our decisions, is manifest and substantial, and it affords a convenient and workable basis of distinction between a direct and immediate burden upon the business affected and a charge that is only indirect and incidental. A tax upon gross receipts affects each transaction in proportion to its magnitude and irrespective of whether it is profitable or otherwise. Conceivably it may be sufficient to make the difference between profit and loss, or to so diminish the profit as to impede or discourage the conduct of the commerce. A tax upon the net profits has not the same deterrent effect, since it does not arise at all unless a gain is shown over and above expenses and losses, and the tax cannot be heavy unless the profits are large. Such a tax, when imposed upon net incomes from whatever source arising, is but a method of distributing the cost of government, like a tax upon property, or upon franchises treated as property; and if there be no discrimination against interstate commerce, either in the admeasurement of the tax or in the means adopted for enforcing it, it constitutes one of the ordinary and general burdens of government, from which persons and corporations otherwise subject to the jurisdiction of the states are not exempted by the Federal Constitution because they happen to be engaged in commerce among the States.[15]

It will be observed that the court carefully distinguished between a tax on gross income and a tax on net income from interstate business as the former had been de-

[10] 266 U. S. 555, 45 Sup. Ct. 184, 69 L. Ed. 439 (1925).

[11] 231 U. S. 68, 34 Sup. Ct. 15, 58 L. Ed. 127 (1913).

[12] 268 U. S. 203, 218, 45 Sup. Ct. 477, 481, 69 L. Ed. 916 (1925).

[13] 216 U. S. 1, 30 Sup. Ct. 190, 54 L. Ed. 355 (1910).

[14] 247 U. S. 321, 38 Sup. Ct. 499, 62 L. Ed. 1135 (1918).

[15] 247 U. S. 321, 328, 329.

clared contrary to the Constitution. There is a real difference between them. Two corporations may have the same sales but the cost of doing business may be much greater for one than the other causing a wide variance in net results. It should be noted that the corporation was organized under the laws of the taxing state and that the business was both domestic and interstate. The actual decision therefore may be limited to those facts even though the language used was quite broad. These points are emphasized because Alpha Portland Cement Co. vs. Mass.[16] decided several years later has been interpreted as prohibiting states from levying an income tax on a foreign corporation engaged solely in interstate commerce.[17] The cement company was a New Jersey corporation having its principal office in Pennsylvania. Traveling salesmen solicited orders in Massachusetts which were accepted in Pennsylvania and shipments were made into Massachusetts from various places outside of the state. That the court did not treat the tax as laid on income is evidenced by its statement that:

> The right to lay taxes on tangible property or on income is not involved; and the inquiry comes to this: May a State impose upon a foreign corporation which transacts only interstate business within her borders an excise tax measured by a combination of two factors; the proportion of the total value of capital shares attributed to transactions therein, and the proportion of net income attributed to such transactions?[18]

The question was answered in the negative. The decision has caused much difficulty. It raises the problem of an excise tax measured by net income—which problem will be discussed later. It is believed that the case does not prevent states from reaching the net income of interstate commerce. Those states which have trouble with excise taxes might well turn to the general income tax. Much of the above has been very well summarized by Magill in the following manner:

> It is evident that a state must frame its corporation excise tax with a careful eye to the formal requirements imposed by the Supreme Court. Some fish will escape its net; it cannot impose this type of tax (though it could impose a property or an income tax) upon a foreign corporation doing a wholly interstate business. But if the corporation does a local business, the state may successfully impose excise taxes, so long as it measures the tax formally by property employed locally, or by local earnings.[19]

What has been said indicates the law on the subject as it stands today. There exists some dissatisfaction with it, however, on the question of what does or does not amount to an invalid burden on interstate commerce. It will be remembered that the Constitution says nothing about taxes or burdens in its provision concerning interstate commerce. It is through the interpretation of the Supreme Court that we have the doctrine that the states may not interfere with the power of Congress to regulate interstate business, or in general, with any agent exercising Federal functions. This was settled long ago by Chief Justic Marshall in McCulloch vs. Maryland,[20] the case in which he made the widely quoted statement that "the power to tax involves the power to destroy." The way in which this theory was later applied to interstate commerce is shown in the statement:

> It is hardly within the scope of the present discussion to refer to the disastrous effects to which the power to tax interstate or foreign commerce may lead. If the power exists in the state at all, it has no limit but the discretion of the state, and might be exercised in such a manner as to drive away that commerce, or to load it with an intolerable burden, seriously affecting the business and prosperity of other states interested in it, and if those states, by way of retaliation, or

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[16] Cited in Note 12, supra.

[17] C. W. Gerstenberg, Report of Committee on Standardization and Simplification of the Business Taxes, 1929 Proc. Nat'l. Tax Ass'n. 152. See also Frederic Sammond, Three Common Constitutional Misconceptions of Income Tax Law, 8 Wis. Law, Rev. 199 (1933); Mabel Newcomer, State Taxation of Interstate Income of Manufacturing Corporations, Vol. 15, Nat'l. Tax Ass'n. Bulletin, p. 10 (1929); R. S. Ford, The Status and Certain Tests of Uniformity in Allocating Corporate Income 17 Nat'l. Tax Ass'n. Bulletin 96 (1932).

[18] 268 U. S. 203, 216. Cited in Note 12, supra.

[19] Roswell Magill, Taxation of Property and Business as Affected by the Commerce Clause, 1932 Proc. Nat'l. Tax Ass'n. 242, 254.

[20] 4 Wheat. 316, 4 L. Ed. 579 (1819).

otherwise, should impose like restrictions, the utmost confusion would prevail in our commercial affairs.[21]

It was assumed by the court that if a state had some power, that it could exercise the power without limit. If it could lay a tax trifling in amount then a prohibitory tax could be laid, it was supposed, and so no tax at all must be allowed if it affects a national power.

This idea was criticized by Justice Holmes in a dissenting opinion in these words:

> But this court which so often has defeated the attempt to tax in certain ways can defeat an attempt to discriminate or otherwise go too far without wholly abolishing the power to tax. The power to tax is not the power to destroy while this court sits.[22]

This seems to be a sound view. The Supreme Court should declare unconstitutional only those taxes that unduly affect or discriminate against a Federal function. There has been a tremendous growth in corporations since the early decisions involving this point and a large part of business today is interstate commerce. Corporations dealing in such business exercise many of the same privileges and receive the same protection as those doing local transactions and it is unfair that they should not have to pay some of the taxes which the latter have to pay. What the state fails to collect from interstate companies it must of necessity take from other sources—very often from competing concerns. It seems unjust that corporations engaged exclusively in foreign commerce should escape a tax under the conditions present in such cases as Ozark Pipe Line Co. vs. Monier[23] and Alpha Portland Cement[24] mentioned above. Other members of the Court besides Justice Holmes have expressed themselves similarly. He and Justice Brandeis concurred in an opinion of Justice Stone who stated:

> Nor can I find any practical justification for this distinction or for an interpretation of the commerce clause which would relieve those engaged in interstate commerce from their fair share of the expense of government of the states in which they operate by exempting them from the payment of a tax of general application, which is neither aimed at nor discriminated against interstate commerce.[25]

Attention is called to the fact that in the quotation above from Pennsylvania vs. West Virginia[26] that the word "discrimination" was used and not the word "burden." It is submitted that any general tax should be permitted and that the regulation of interstate commerce could be adequately protected by declaring invalid only those taxes which are actually discriminatory. We have seen that a tax on the property used in interstate business and a tax on the net income arising from interstate transactions are constitutional, and yet they must be paid by such commerce indirectly. The test should not be whether the tax is direct or indirect but whether the tax operates unfairly against the interstate commerce as compared with other commerce.

TAXES MEASURED BY NET INCOME

The average person, no doubt, would see little difference between a tax on a certain thing and a tax on something else measured by that thing. The Supreme Court has often found that there is a distinction. In 1909 Congress placed a tax on corporations on the privilege of doing business in the corporate capacity, which tax was measured by the net annual income of each company. The statute was soon thereafter construed to be an excise tax on the doing of business in a certain way, and not an income tax, although the amount was determined by net income and notwithstanding that some of the income was derived from tax exempt municipal bonds. The court said:

> It is therefore well settled by the decisions of this court that when the sovereign authority has exercised the right to tax a legitimate subject of taxation as an exercise of a franchise or privilege,

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21 122 U. S. 326, 346. Cited in Note 6, supra.
22 Panhandle Oil Co. vs. Miss. ex Rel Knox, 277 U. S. 217, 223, 48 Sup. Ct. 451, 72 L. Ed. 857, 859 (1928).
23 Cited in Note 10, supra.
24 Cited in Note 12, supra.
25 Helson vs. Kentucky, 279 U. S. 245, 253, 49 Sup. Ct. 279, 73 L. Ed. 683 (1929).
26 Cited in Note 2, supra.

it is no objection that the measure of taxation is found in the income produced in part from property which of itself considered is non-taxable.[27]

The view that the tax was not direct but an excise was necessary in order to sustain it. Pollock vs. Farmers Loan and Trust Co.[28] had ruled the income tax Act of 1894 a direct tax and therefore in violation of the Constitution which required direct taxes to be apportioned among the states. The two taxes were distinguished on the ground that one was on the actual doing of business under the corporate type of organization while the other was imposed because of ownership of property. According to this view the Sixteenth Amendment to the Constitution was not necessary so far as corporate income was concerned.

The State of New York levied a tax on foreign manufacturing and mercantile corporations for the privilege of doing business in New York which was computed by taking a percentage of the net income for the preceding year for each corporation. This tax was ruled in Bass, Ratcliff and Gretton vs. State Tax Commission[29] to be not a direct tax on the income but a privilege tax measured by the income.

In 1927 a limitation was placed on the principle set forth in the Flint case. In Miller vs. Milwaukee,[30] Wisconsin attempted to tax dividends received from Wisconsin corporations to the extent that they were paid from interest on United States bonds credited to surplus. Under the law stockholders were not taxed where the corporation paid a tax upon its entire income but if only a part of the corporate income was assessed then only a corresponding part of the dividends received was exempt. The court declared the state law bad, as it was designed to do indirectly what could not be done directly. A new element was thus introduced in testing the validity of a statute; i.e., the purpose back of it. An analogous question arose a short time later in Macallen Co. vs. Massachusetts.[31] There the State of Massachusetts imposed an excise tax on a domestic corporation which owned United States Liberty Bonds, Federal Farm Loan Bonds, and other securities. The tax was for the privilege of doing business and was measured by net income which included interest on the above securities. This income under the law as originally drawn was expressly exempted. The majority of the court concluded that the legislature had an unlawful purpose in mind when it amended the act to include interest collected from United States bonds. Justice Stone in a dissenting opinion concurred in by Justices Holmes and Brandeis saw no such sinister purpose. The majority also looked upon Flint vs. Stone Tracy as being an extreme case but did not overrule it. The decision left the law in this field in an unsettled state. Since legislative motive is a difficult thing to determine, and ordinarily is not considered in tax cases, it made the validity of any particular statute very uncertain.

The question came up again in Educational Films Corporation vs. Ward when the court had before it another New York law which laid an annual tax on each domestic corporation for the privilege of exercising its franchise. The rate was $4\frac{1}{2}\%$ of that part of the entire net income for the preceding year as was allocated to the state. The question was whether the measure of the tax could include income from copyrights when such Federal instrumentalities could not be directly taxed. The court upheld the tax which was not found to be aimed at copyrights, and in the course of the opinion made this statement:

> It is said that there is no logical distinction between a tax laid on a proper object of taxation, measured by a subject-matter which is immune, and a tax of like amount imposed directly on the latter; but it may be said with greater force that there is a logical and practical distinction between a tax laid directly upon all of any class of government instrumentalities, which the Constitution impliedly forbids, and a tax such as the

[27] Flint vs. Stone Tracy Co., 220 U. S. 107, 165, 31 Sup. Ct. 342, 55 L. Ed. 389 (1911).
[28] 157 U. S. 429, 15 Sup. Ct. 673, 39 L. Ed. 759 (1895).
[29] 266 U. S. 271, 45 Sup. Ct. 82, 69 L. Ed. 282 (1924).
[30] 272 U. S. 713, 47 Sup. Ct. 280, 71 L. Ed. 487 (1927).
[31] 279 U. S. 620, 49 Sup. Ct. 432, 73 L. Ed. 874 (1929).

present which can in no case have any incidence, unless the taxpayer enjoys a privilege which is a proper object of taxation, and which would not be open to question if its amount were arrived at by any other non-discriminatory method.[32]

It is interesting to note here that since this decision we have Fox Film Corporation vs. Doyal[33] holding, without dissent, that copyrights are not instrumentalities of the Federal Government and that gross receipts of royalties are subject to state taxation. Educational Films was said not to apply since the tax was not based on net income, but of course a case exactly like it would not arise now. If gross receipts from copyrights are taxable there certainly would be no question about the validity of a tax on the net income. Not long before in a five-four decision, Long vs. Rockwood,[34] Massachusetts was not allowed to tax the income derived from patents but that case was definitely overruled.

Facts very similar to those in the Macallen case were present in the recent case of Pacific Company vs. Johnson[35] but the court came to a different conclusion. Again we had a corporate franchise tax with net income used as the yardstick in ascertaining the amount. The California statute involved expressly included in the net income the income from tax exempt bonds. The majority of the court found no discrimination while Justice Sutherland dissenting with Justices Van Devanter and Butler thought the legislature intended to reach an illegal object just as in the Macallen case and could see no real distinction between them. The reason why the tax in Miller vs. Milwaukee was bad, it was explained, was because the measure of the tax there used excluded all income except that from government bonds. It seems then that the principle emphasized in Educational Films is still followed—that a non-discriminatory tax of the kind under discussion is valid even though it has an incidental effect on the federal government.

The facts in Alpha Portland Cement vs. Massachusetts[36] have been briefly stated. The tax in that case was measured in part by net income which measure itself would have been taxable but the tax was held bad because the subject was bad. The decision has been much discussed and criticized. One reference to it follows:

> The decision boils down to this (Alpha Cement): Even though it be conceded that a tax on property may be imposed on property employed in interstate commerce and that a tax on net income may be imposed on net income from interstate commerce, nevertheless an excise on doing business measured by property properly taxable and by net income properly taxable may not be imposed if the only business done is interstate commerce.
>
> So be it, since it is so held. The thing for Massachusetts to do now is to get out its baptismal font and re-baptize its tax into a tax *on* net income and a tax *on* property.[37]

It is not proposed here to discuss the cases where excise taxes have been measured by means other than net income. The results of a few of the decisions, however, will be briefly stated. It has already been noted that a direct tax upon gross receipts derived from interstate commerce is unconstitutional.[38] But taxes have been sustained on companies doing interstate business where their gross receipts were used as an index or measure of the taxes.[39] Another tax similarly calculated was ruled bad in a divided opinion as being merely an attempt to tax the gross receipts themselves, the majority saying:

> The distinction between a tax "equal to" one per cent of gross receipts, and a tax of one per cent of the same, seems to us nothing, except where the former phrase is the index of an actual attempt to reach the property and to let the interstate traffic and the receipts from it alone.[40]

[32] 282 U. S. 379, 391, 51 Sup. Ct. 170, 75 L. Ed. 400 (1931).
[33] 286 U. S. 123, 52 Sup. Ct. 546, 76 L. Ed. 1010 (1932).
[34] 277 U. S. 142, 48 Sup. Ct. 463, 72 L. Ed. 824 (1928).
[35] 285 U. S. 480, 52 Sup. Ct. 424, 76 L. Ed. 893 (1932).
[36] Cited in Note 12, supra.
[37] T. R. Powell, Business Taxes and the Federal Constitution, 1925 Proc. Nat'l. Tax Ass'n. 164, 172.
[38] Cited in Note 6, supra.
[39] Maine vs. Grand Trunk R. Co., 142 U. S. 217, 12 Sup. Ct. 121, 35 L. Ed. 994 (1891). Pullman Co. vs. Richardson, 261 U. S. 330 (1923).
[40] Galveston H. & S. A. Ry. Co. vs. Texas, 210 U. S. 217, 227, 28 Sup. Ct. 638, 52 L. Ed. 1031 (1908).

In the Crew Levick case cited above[41] it was held that a state tax measured by the gross business transacted in interstate commerce was a regulation of that commerce. In Panhandle Oil Co. vs. Mississippi the court said:

> To use the number of gallons sold the United States as a measure of the privilege tax is in substance and legal effect to tax the sale.[42]

Capital stock has frequently been used as the measure of taxes. In the Western Union Case[43] a privilege tax based on the total authorized capital of a foreign corporation was held bad as a burden on interstate business as the capital stock represented all of the company's business and property. A few years later an excise tax of a certain per cent of the authorized capital stock of a foreign corporation but which was limited in amount was upheld.[44] The decision in that case, however, was not followed when the same kind of tax again came before the court.[45] An annual fee levied on a foreign corporation for the privilege of exercising its franchise ascertained by taking a part of the authorized shares was ruled invalid as the authorized shares were greatly in excess of those actually outstanding.[46]

It is not to be inferred that a large number of these decisions are inconsistent. The cases have been cited to show that there is no simple rule which can be used to test the validity of a tax on one thing measured by something else. It seems that all of the surrounding circumstances in each case are considered which aid the court in determining just what is in fact being taxed. That the tax is in lieu of other taxes, that it is small in amount, that it shall not exceed a definite limit, that it is not discriminatory, are examples of factors which have favored its validity.

It is apparent, though, that there is much uncertainty and confusion in this field of taxation.

TREATING THE WHOLE BUSINESS OF A COMPANY AS A SINGLE SYSTEM —THE UNIT RULE

We have seen that a general net income tax may be collected by a state from corporations transacting interstate business. The legality of such a tax seems reasonably well settled but the determination of the amount of the tax presents many difficulties which have not been satisfactorily overcome. Each state should tax only that income which is produced within its borders. But how much of the total income of a company is earned in one state when it carries on essential operations in three or four states? That is the question before every state which levies an income tax upon corporations and, to date, each state has its only particular answer. There are two general ways of attacking the problem. Separate accounting may be used where the nature of the business permits and where proper records are kept. Various allocation formulas have been developed as a second method which must be resorted to where the items of income and expense are not or cannot be directly assigned to the state. Such would be the case where a concern deals in a series of related transactions and no basis exists for separating them into distinct parts. This type of enterprise was recently described and compared with others in these words:

> . . . its business is unitary. That term is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business—a business, the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units. By contrast, a dual or multiform business must show units of a substantial separateness and completeness, such as might be maintained as an independent business, and capable of producing a profit in and of themselves.[47]

The unitary theory developed as a method of ascertaining the value of property used in

[41] Cited in Note 7, supra.
[42] 277 U. S. 217, 222, 48 Sup. Ct. 451, 72 L. Ed. 857, 859 (1928).
[43] Cited in Note 13, supra.
[44] Cited in Note 11, supra.
[45] Cudahy Packing Co. vs. Hinkle, 278 U. S. 460, 49 Sup. Ct. 204, 73 L. Ed. 454 (1928).
[46] Air-Way Electric Appliance Corp. vs. Day, 266 U. S. 71, 45 Sup. Ct. 12, 69 L. Ed. 169 (1924).
[47] Maxwell vs. Kent Coffey Mfg. Co., 204 N. C. 365, 168 S. E. 397, 399 (1933).

interstate commerce. For example, the mileage of railroad tracks within a state as compared with the total mileage was taken as the proportion of the total going value assignable to the state.[48] This rule was used in Adams Express Co. vs. Ohio even though the physical property within the taxing state was relatively small, the court saying:

> No more reason is perceived for limiting the valuation of the property of express companies to horses, wagons, and furniture, than that of railroad, telegraph, and sleeping-car companies to roadbed, rails, and ties; poles and wires; or cars. The unit is a unit of use and management, and the horses, wagons, safes, pouches, and furniture; the contracts for transportation facilities; the capital necessary to carry on the business, whether represented in tangible or intangible property, in Ohio, possessed a value in combination and from use in connection with the property and capital elsewhere, which could as rightfully be recognized in the assessment for taxation in the instance of these companies as the others.[49]

It was further pointed out that a unity of ownership alone was not enough; that a manufacturing company and a store under a common ownership but located in different states would be separate businesses.

Certain limitations were later placed on the unit principle. A state with less than eight thousand dollars worth of property within its borders, belonging to a certain company, was not permitted to include in its assessment ratio several million dollars worth of property outside the state which was not used in the business of the company.[50] The assumption that the value of a railroad was evenly distributed in accordance with its main track mileage was held not warranted where the land of the taxing state was comparatively level and where valuable terminals were in other states.[51]

There have been several income tax decisions in which the unitary doctrine was ruled inapplicable.

The apportionment of the total income of a company on the basis of mileage was held bad in a case where the company had two disconnected railroad lines, one wholly within the taxing state and the other entirely outside. The earnings per mile of the latter were greater than for the line inside so the tax improperly reached income earned outside the state.[52]

The plaintiff in Standard Oil Co. vs. Thoresen[53] was engaged in marketing refined oils in the State of North Dakota. The production and refining processes were carried on in other states. The state contended unsuccessfully that the business should be treated as a unit. The court found that the market value of the oil in the state at any time could be readily determined. This decision was followed in a similar case where the plaintiff did practically no manufacturing in Wisconsin but maintained tanks and filling stations there. Nearly half of the oil stored in Wisconsin was sold outside the state. All products shipped into Wisconsin were charged to the business of that state at market prices. The Supreme Court of the state, in ruling against the tax commission, said:

> The statute does not enjoin upon the commission the use of that method which will produce the largest amount of taxable income, but rather that method which will most justly apportion the income properly taxable in Wisconsin. Here it appears conclusively that it is possible to ascertain the income derived from business transactions in Wisconsin by the application of proper accounting methods.[54]

It is seen that in both of the Standard Oil cases the manufacturing operations were separated from the business of the selling departments by means of market values. It is on this point that the cases are distinguished from those in which the concerns were treated as a single unit for purposes of taxation. These two decisions do not necessarily render allocation formulas useless.[55] Very

[48] Cited in Note 3, supra.

[49] 165 U. S. 194, 221, 222, 17 Sup. Ct. 305, 41 L. Ed. 683 (1897).

[50] Fargo vs. Hart, 193 U. S. 490, 24 Sup. Ct. 498, 48 L. Ed. 761 (1904).

[51] Wallace vs. Hines, 253 U. S. 66, 40 Sup. Ct. 435, 64 L. Ed. 782 (1920).

[52] Piedment & N. Ry. Co. vs. Query, 56 F. 2d. 172 (1932).

[53] 29 F. 2d, 708, C. C. A. 8th Cir. (1928).

[54] Standard Oil Co. vs. Wis. Tax Com., 197 Wis. 630, 638, 223 N. W. 85 (1929).

[55] See Mabel Newcomer, State Taxation of Inter-

often fair market values would not be available. In many cases the ordinary manufacturing company would not find it possible or practicable to accurately separate the producing and selling transactions. The courts could easily find in a more or less complex situation that the accounting methods used do not show a proper division of the net income.

While the idea that a corporation which makes and sells goods is ordinarily a unitary business was expressed in Hans Rees' Sons vs. North Carolina,[56] the Supreme Court of the United States viewed the evidence produced by the company as showing that the North Carolina allocation statute operated to reach profits not attributable to that state.

The company manufactured and sold leather. It was incorporated in the State of New York and maintained a warehouse and sales office in that state. Its tannery in North Carolina was used as the manufacturing plant and supply house. From it shipments were made to the warehouse in New York and directly to customers on New York orders. The company undertook to divide its total income into three distinct parts: that derived from buying, from manufacturing, and from selling. It was said that the buying profit came from skillful purchases in a fluctuating hide market; that the manufacturing profit resulted from savings in the cost of its own tanning operations as compared with the cost of tanning done by contract; and that the selling profit came from cutting the leather in such a way as to meet the needs of individual customers. The state court looked upon these operations as component parts of a single unit, but the Supreme Court held that even though a particular enterprise was unitary in that the ultimate gain came from all of its activities, yet the apportionment should not be made regardless of evidence.

The evidence offered is not set out in detail and it does not appear exactly how or to what extent the company attributed its income to each of the three sources alleged. It is submitted that that would be a very difficult thing to show and it is doubtful if tax commissions and the courts should undertake to pass upon any such attempts. The problem resembles the old one of ascertaining which leg is the most important leg of a three-legged stool.

ALLOCATION FRACTIONS AND THE SUPREME COURT

The allocation fraction has been defined as:

> the means whereby the total net income or the total valuation of a business concern is split up and given a situs in a given jurisdiction to avoid the well-nigh impossible task of assigning to that jurisdiction, item by item, the specific elements of income or value which would be accounted for in that jurisdiction if the business done therein were considered a separate accounting unit.[57]

Where it is determined that the unitary theory is applicable, there still remains the difficult problem of dividing up the total income among those states in which the various processes producing the income have been carried on. The device which has been resorted to by the states is the selection of certain activities which take place within the state and are measurable and which when compared with the total activities of the taxpayer will indicate, it is assumed, the proportion of its total income which is earned within the state. Expressed in the form of a fraction it is:

$$\frac{\text{State Activities}}{\text{Total Activities}} \times \text{Total Net Income} = \text{Income}$$

taxable by the State.

Several kinds of fractions have been considered by the United States Supreme Court. The Wisconsin formula upheld in U. S. Glue Co. vs. Oak Creek,[58] at that time, consisted of gross business and property in dollars in the state over total gross business and property in dollars within and without

state Income of Manufacturing Corporations, Vol. 15 Nat'l. Tax Ass'n. Bulletin, p. 10 (1929). Cited in Note 17, supra.

[56] 283 U. S. 123, 51 Sup. Ct. 385, 75 L. Ed. 879 (1931).

[57] Report of Committee on Standardization and Simplification of the Business Taxes. C. W. Gerstenberg 1929 Proc. Nat'l Tax Ass'n 152, 153.

[58] Cited in Note 14, supra.

the state. Two years later a Connecticut statute came up in Underwood Typewriter Co. vs. Chamberlain[59] which taxed such proportion of the whole net income of foreign corporations as the value of their real and tangible personal property within the state bore to all of their real and tangible personal property. The company was a Delaware corporation with its main office in New York, and branch offices in various states. Its manufacturing was done entirely in Connecticut while the greater part of its sales were made through branches outside the state. Application of the statute resulted in a fraction equal to 47 per cent. The company attempted to show that nearly all of its net profits were received in other states but it failed to convince the court that the proportion of 47 per cent was unreasonable. Quoting from the opinion:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State.[60]

A New York statute was next considered in 1924 in the case of Bass, Ratcliff and Gretton vs. State Tax Company.[61] The plaintiff corporation brewed and sold ale. It was organized in England where all of its brewing was done and a large part of its sales were made. Branch sales offices were located in New York and Chicago. The ratio used in taxing the company included real and tangible personal property, notes and accounts receivable arising out of the business, and certain shares of stock given a situs in accordance with the location of the physical property back of the stock. The reasoning of the Underwood case[62] was followed in upholding the statute. In both these cases the court did not find the method adopted to be arbitrary, unreasonable, or an effort to reach profits produced outside, or that the complaining taxpayer had carried the burden of showing these things. The emphasis placed on the latter point no doubt will encourage companies to offer in evidence detailed compilations such as were submitted in the Hans Rees' case.[63] The taxpayer will be given an opportunity to show that the actual net income earned within the state was some other amount than that indicated by the statutory fraction. This privilege gives him an advantage over the taxing authorities because he will attempt to make this showing of course only when the tax would be less. Where the tax would be greater no data will be presented and the allocation fraction will be used. It is not sufficient, however, to merely object to the use of a fraction, the burden must be assumed of showing what the courts will consider to be the true income. Nor will the fraction be declared invalid because it includes only part of the income producing activities. For example, the important factor of sales was omitted in Underwood Typewriter Co. vs. Chamberlain[64] and in the Bass, Ratcliff and Gretton case.[65] A state court in the recent decision of Maxwell vs. Kent Coffey Mfg. Co.[66] upheld an allocation formula that attributed practically all of the net income of a manufacturing company to the State of North Caroline although nearly all of the sales were made without the state. The formula was made up from the fair cash value of real estate and tangible personal property. It would obviously throw the bulk of the income to the state in which the manufacturing was done even though other factors might be responsible for a large share of the profits.

The position of the courts with respect to the difficulties inherent in the use of allocation formulas has been expressed as follows:

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[59] 254 U. S. 113, 41 Sup. Ct. 45, 65 L. Ed. 165 (1920).
[60] 254 U. S. 113, 120, 121 Cited in Note 59, supra.
[61] Cited in Note 29, supra.
[62] Cited in Note 59, supra.
[63] Cited in Note 56, supra.
[64] Cited in Note 59, supra.
[65] Cited in Note 29, supra.
[66] Cited in Note 47, supra.

The most that a court can do is to spot something clearly bad, and much that is clearly questionable is not clearly bad. Judicial condonations of modes of allocation should, therefore, not be taken as tokens that those modes are the best that can be devised. Doubtless there is no such animal as an intrinsically good ratio. The best that can be hoped for is a good stab at a good ratio. More important than a good ratio is the adoption of identical ratios by the several states.[67]

AFFILIATED CORPORATIONS

With such complex corporate interrelationships as exist today the question was bound to arise as to the applicability of the unitary theory and apportionment fractions in the case of companies affiliated through stock ownership. As long as there are states without income tax laws, or marked differences exist in the laws of those states which do tax corporate income, it is to be expected that transactions between related corporations will be so arranged as will tend to keep down taxes. Sales and purchases may be made between parent and subsidiary companies at fictitious prices, or the profits of subsidiaries limited by various contracts, management fees, or other charges. In many cases the concerns are so closely related as to be virtually departments or branches of a single business with little possibility of accurately assigning a definite profit to each. Consolidated returns have been required as a solution to the problem. The total consolidated profit reported is then divided up in accordance with the regular apportionment formulas. Where the profit and loss statements of a number of companies under one control are properly combined, intercompany transactions are eliminated and all other items of expense and income are presented as they would be in the case of a single company. The combined statements show the condition or operating results of the entire organization in relation to the outside world. Though it be true that a corporation is a legal entity and in that sense separate and distinct from another company which owns its stock, yet from a practical standpoint its assets and operations are controlled by the other company. In order to arrive at the true profit it may be necessary to disregard the entity idea, and the consolidated return as developed and used in regular accounting practice furnishes the means for doing so.

There have been several important decisions where affiliated interests were involved. In Cliffs Chemical Co. vs. Tax Commission[68] a company operating in Wisconsin attempted to transfer a large part of its profits to a shareholding corporation outside the state by distributing to it manufactured products at cost. The State Supreme Court looked upon the plan as a scheme to evade taxes and upheld the Tax Commission's assessment based on market values for the product.

The Studebaker Corporation which was organized in New Jersey sold motor cars in the State of New York through a company there under an agreement whereby the parent company shipped to it at the retail list price less fixed percentages. The terms of the contract were such that the New York company showed substantial operating losses for a couple of years. These losses were absorbed by the parent company which made large profits during the same period of time. The State Commission determined that the net income taxable by New York should be the same as though the parent company had transacted the business in that State. This was approved as a fair method in the absence of data showing otherwise. The court said:

> It is very clear that the very large profits of the parent corporation . . . were made at the expense of its subsidiaries and since the parent corporation took over the losses, notwithstanding its contract with its subsidiary, the agreement was manifestly not the proper basis for estimating the fair profits which, but for the agreement, could have been obtained by the relator, and was made for the purpose of avoiding income taxation in this state.[69]

The situation of a manufacturing company in one state and a related sales organization in another state was present in the

[67] Cited in Note 37, supra. Page 184.

[68] 193 Wis. 295, 214 N. W. 447 (1927).

[69] 216 N. Y. Sup. 208, 210 (1926).

case of Palmolive Company vs. Conway.[70] The parent company, the Palmolive-Peet-Colgate Co. of Delaware, agreed to take the product of the Wisconsin company for the years 1925 and 1926 at factory cost plus 6 per cent. This contract caused a marked reduction in total sales and gross profits of the latter company as compared to previous years. The profits of the factory and the sales company were consolidated by the Tax Commission and the combined figure apportioned according to the Wisconsin statutes. This method was upheld by the decisions. The court concluded that the intercorporate relations under the circumstances shown constituted a fraud upon the Wisconsin income tax laws. The corporations had practically the same officers and directors. It was pointed out that when other companies manufactured soap upon a cost plus basis that they did so for only a small part of their total production.

Another type of contract which limited gross profits was involved in Buick Motor Company vs. City of Milwaukee.[71] The plaintiff was a subsidiary sales corporation in Wisconsin under contract to buy from the parent company, the General Motors Corporation, automobiles and parts upon such a basis that the former's net profit should amount to $2,500 per year. This figure was clearly fictitious as it was well known that there was a high volume of sales. The Tax Commission ascertained the income of the Wisconsin company by treating it as an independent distributer. Sufficient records were obtainable to determine the profit on that basis, the intercompany contract being entirely disregarded. Overhead costs were allocated to Wisconsin on the basis of sales and Federal income taxes on the basis of income. This case furnishes an example where the Tax Commission determined the profits without consolidated returns but nevertheless was permitted to look behind the corporate entity in order to get at the true facts.

The decision was upheld on appeal where the court remarked:

> Whatever other purpose such a contract might have, the conclusion seems quite irresistible that one of its objects was to transfer the income arising from the business of such states as then had, or might thereafter enact, an income tax law, so that the income would not be taxable in the state where earned. This motive might not alone warrant the state in ignoring the contract, but if appellant, notwithstanding the contract, continued to earn the income upon business transacted within the state, the contract would not serve to defeat the right of the state to tax the income so earned.[72]

Burroughs Adding Machine Co. vs. Tax Commission was considered at the same time that the Buick case was before the courts. No written opinion was filed but substantially the same views were expressed. The net profit of the sales company in Wisconsin was limited to a certain per cent of the capital stock. A consolidated return was requested but was refused. The Tax Commission then made a doomage assessment which the Federal Court directed the corporation to pay. This case illustrates the use of a weapon which is available to a state where it has no jurisdiction to compel consolidated statements from a foreign corporation. An assessment may be made upon what information is available or according to the best judgment of the tax commission. The taxpayer then has the burden of proof to show that the assessment is incorrect.

That the emphasis placed upon fraud in some of the decided cases may place a heavy burden of proof upon the state has been expressed in an article dealing with affiliated corporations. The writer points out how difficult it may be for a state to show fraud, to prove that contracts are unfair, or that the subsidiary is actually controlled by the parent company where the companies have carefully arranged all details and have gone through the proper forms. He suggests that:

> . . . The presumption, which it is submitted a statute could create, would be that affiliated companies have a unity of use. This presumption, which would of course be subject to refutation by the taxpayer, would simply extend the doctrine that unity of use is presumed of all the property

[70] 37 Fed. (2d) 114, 43 Fed. (2d) 226, 56 Fed. (2d) 83, W. D. Wis. (1930).

[71] 43 Fed. (2d) 385, E. D. Wis. (1930).

[72] Buick Motor Co. vs. City of Milwaukee, 48 Fed. (2d) 801, 803, C. C. A. 7th Cir. (1931).

of one corporation to that of affiliated corporations. What constitutes affiliation could be defined as a fixed percentage of stock ownership by the same interests. Minor hardships suffered by a few parties should be permitted as part of a taxing system designed to prevent what is probably a widespread practice of shifting assets and income among affiliates to minimize taxation.[73]

That states will meet difficulties along this line has been recently demonstrated in Curtis Companies, Inc. vs. Wisconsin Tax Commission.[74] The plaintiff was a holding company owning practically all of the shares of a producing company in Wisconsin which reported income under the separate accounting method. It was claimed by the state that the true income was not reflected due to the arbitrary allocation of advertising and general administrative charges, the rental charged for the use of the plant which was owned by the plaintiff, and the fixed percentage of gross profit allowed the producing company on sales to distributing subsidiaries. The state attempted to consolidate the incomes of the companies and make an apportionment of the total income. It was contended that this was the proper basis if taxes would otherwise be avoided and that it was not necessary to show intent on the part of the taxpayer to evade income taxes. The Supreme Court of Wisconsin did not agree with this contention. The Wisconsin statutes[75] dealing with corporate tax evasion and consolidated statements were held not applicable as it was not shown that the intercorporate contract was unfair and that it was used in order to avoid the income tax law. That there was no proof of attempted tax evasion, it was said, distinguished the case from the Cliff Chemical, Palmolive and Buick cases described above.

The decision may be explained on the ground that the court interpreted the statutes as not granting to the Tax Commission the power it claimed; not that the legislature could not have granted such powers. The result, nevertheless, is unfortunate. The taxing authorities should possess such powers as are necessary to assess taxes on what may be ascertained as the true income. Much income will escape taxation if a state can question intercorporate transactions and arrangements only when it can prove that they represent devices used with intent to conceal profits.

THE WISCONSIN FORMULA AND RELATED STATUTES

It is necessary to make a careful study of the laws of a particular state in order to see what problems are involved in the taxing of income in which other states are interested. The State of Wisconsin has taxed income since 1911, or longer than any other state using a modern income tax law. The Wisconsin statutes will serve well to illustrate a number of points and to make the discussion more definite. The following outline of the Wisconsin statutes dealing with our problem shows the income divided into two main classes:[76]

A. Income which follows the situs of the:
   1. Business
      Transacted within state.. Where within and without, income determined by:
      a. Separate accounting
      b. Apportionment
      c. By Tax Commission in exceptional cases
   2. Property
      Real estate and tangible personal property, by:
      a. Operation
      b. Sale
      c. Lease

B. Income which follows the residence of the recipient:
   1. Intangible personal property (Except where it constitutes the stock in trade of a business).
   2. Personal service
      Mental and physical labor

All business income derived in whole or in part in the state is taxable. Where the busi-

[73] Application of the Unit Rule to Affiliated Corporations, 32 Col. Law Rev. 513, 521 (1932).

[74] 214 Wis. 85, 251 N. W. 497, 92 A. L. R. 1065 (1934).

[75] Sec. 71.25 (1) and (2) Wis. Stats.

[76] Sec. 71.02 (3) (c) and (d), Wis. Stats.

ness is carried on within and without the state only the income from such business as is transacted within the state is subject to tax. This is true for both residents and non-residents as the test does not depend on residence.

Income derived from tangible property may be obtained from its operation, its sale, or its lease, and is taxable if the property is located in Wisconsin. This rule applies irrespective of the residence of the person receiving the income. Although Wisconsin might have the power to tax the income of a resident of the state derived from tangible property located outside the state, yet it makes no attempt to do so. This seems a highly desirable practice but one that is not followed in all states. The State of New York recently included the rental received from real estate situated in Ohio and also the profit made on the sale of a portion of the property there in the calculation of the income of one of her residents. The courts of that state ruled that the rental income was not taxable and gave as their authority the following which was taken directly from the Pollock vs. Farmers Loan and Trust Co. case: "An annual tax upon the annual value or annual user of real estate appears to us the same in substance as an annual tax on the real estate, which would be paid out of the rent or income."[77] The tax on the profits from the sale, however, was upheld on the theory that these profits were not so directly connected with the real estate. The court cited Willcuts vs. Bunn, 282 U S. 216, 51 S. Ct. 125, 75 L. Ed. 304, 1931 that:

> The tax upon profits made upon purchases and sales is an excise upon the result of the combination of several factors including capital investment and, quite generally, some measure of sagacity; the gain may be regarded as "the creation of capital, industry, and skill."

Income from intangibles is assigned according to the place of residence of the income receiver. Wisconsin thus follows the rule of mobilia personam sequuntur. The test of taxability is the residence of the recipient of the income regardless of where the services were performed or the location of the personal property. The above is made applicable to corporations by Section 71.02 (3) (e)[78] which states that the residence of a corporation shall be determined by the location of its principal business no matter from which state it received its charter. The purpose of this section is no doubt to prevent a corporation from escaping taxation of the income of intangibles by merely incorporating in some other state which has no income tax law. Since the residence of a corporation is ordinarily considered to be that of the state granting its charter it is doubtful if some

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[77] Pierson vs. Lynch, 237 App. Div. 763, 263 N. Y. Supp. 259 (1933).

The statement taken from the Pollock case is widely quoted and has been interpreted in different ways. The principle there set forth was used as recently as 1932 by the Supreme Court of Illinois in Bachrach vs. Nelson 349 Ill. 579, 182 N. E. 909, as a basis for holding the 1932 Illinois Income Tax Statute unconstitutional. The constitution of the State of Illinois provided that the Legislature could impose only occupation, franchise, or privilege taxes, and property taxes based on value. The income tax was ruled invalid because it was on property and not levied in proportion to value. The court quoted with approval from the Opinion of the Justices, 220 Mass. 613, 624; 108 N. E. 570, 574; 1915 that "A tax upon the income of property is in reality a tax upon the property itself. Income derived from property is also property. Property by income produces its kind—that is, produces property and not something different."

The same argument was presented in an attempt to have the Wisconsin Income Tax Law declared invalid but the contention was answered in these words of the court:

"The inapplicability of the rule of the Pollock Case here presented seems so plain as to require little comment. There can be no doubt of the proposition that income taxation of a progressive character, in addition to taxation of property, is directly authorized by the Constitution of Wisconsin as amended in 1908. Words could hardly be plainer to express that idea than the words used. From them it clearly appears that taxation of property and taxation of incomes are recognized as two separate and distinct things in the state Constitution. Both may be levied, and lawfully levied, because the Constitution says so. However philosophical the argument may be that taxation of rents received from property is in effect taxation of the property itself, the people of Wisconsin have said that 'property' means one thing, and 'income' means another; in other words, that income taxation is not property taxation, as the words are used in the Constitution of Wisconsin." State vs. Frear, 148 Wis. 456, 134 N. W. 673, 689, 1912.

[78] A foreign corporation whose principal business is carried on or transacted in Wisconsin shall be deemed a resident of this state for income tax purposes, and its income shall be determined and assessed as if it were incorporated under the laws of Wisconsin, notwithstanding its domicile is elsewhere. Sec. 71.02 (3) (e) Wis. Stats.

other state can domesticate it for tax purposes. The legality of this section of the Wisconsin Act has been ably discussed by Edmund B. Shea who stated:

> The statutory provision in question therefore would permit multiple taxation, and to uphold its validity would be wholly inconsistent with the thought of the supreme court expressed in its most recent declarations on that subject. The clause represents a frank attempt to tax non-residents upon income earned beyond the protection of the laws of the taxing sovereignty and respecting which the latter renders no equivalent to the taxpayer.[79]

The application of the apportionment method of reporting is illustrated by the following:

[79] Limits on State Power to Tax Incomes of Foreign Corporations, Marquette Law Rev. Feb. 1934, page 79.

	Wis.	Total	
(1) Non-Apportionable Income			
(a). Income which follows situs of property			
Profits from sale of capital assets	$10,000	$12,000	
Rents from Real Estate	3,000	5,000	
Less: related expenses	(700)	(1200)	
(b) Income which follows residence of recipient			
Dividends on stock	4,000	4,000	
Interest on bonds and securities	2,000	2,000	
Total non-apportionable	$18,300	$21,800	
(2) Apportionment Fraction			
(a) Tangible Property Used			
Land	$70,000	$70,000	
Buildings	180,000	180,000	
Machinery and Equipment	75,000	85,000	
Furniture and Fixtures	3,000	3,000	
Stocks of Goods	30,000	35,000	
Goods in Process	7,000	7,000	
Raw Material	8,000	8,000	
	$373,000	$389,000	
Less: depreciation	100,000	104,000	
	$273,000	$285,000	
	Wis.	Total	
Less: net value of above not used in producing apportionable income	23,400	25,000	
	$259,600	$260,000	96%
	Wis.	Total	Ratio
(b) Cost of Manufacturing			
Goods used	$50,000	$50,000	
Labor	85,000	98,000	
Overhead	90,000	102,000	
	$225,000	$250,000	90%
(c) Sales	450,000	1,500,000	30%
			3)216%
Average ratio for apportionment			72%
(3) Total Income		$200,000	
Less: All non-apportionable Income (1)		21,800	
Apportionable income		$178,200	
72% to Wisconsin (2)		$128,304	
Add: Non-apportionable Income for Wisconsin (1)		18,300	
Total taxable income for Wisconsin		$146,604	

It will be noted that the income which follows the situs of the property and the residence of the recipient is calculated separately and is deducted from the total income of the business in arriving at the apportionable income. This provision meets certain constitutional requirements which must be observed as is indicated in the decision of Alpha Portland Cement Co. vs. Knapp[80] written by J. Cardozo. In that case the New York statute which placed a tax upon foreign corporations was declared unconstitutional in so far as it taxed income irrespective of the situs of the assets from which the income was derived. The income from bonds and other securities was included in the income taxed although the securities themselves were not considered in the method of allocating the assets.

Another section (71.02 (3) (d) 4.) permitting the Tax Commission to use in exceptional cases such rules as may be necessary in order to arrive at a fair income, may prevent the entire apportionment statute from being declared unconstitutional in some case where it would clearly give an inequitable result. One or more of the ratios may be excluded when the factors from which they are calculated are not present in the business or are comparatively unimportant. A corporation may, for example, buy all of the goods it sells, or it may buy a considerable amount and make the rest. Either situation can be met by eliminating the cost of manufacturing ratio or by giving it less than full weight. It will be observed from the illustration given above that the final apportionment percentage which is applied to the apportionable income is obtained by taking the arithmetical average of three separate percentage figures. It has been suggested that a better and more simple method would result if the several elements themselves were combined and thus an automatic weighting obtained in each case.[81] This method was used at one time and it is said that it frequently gave more weight to certain factors than was justified by what was thought to be their contribution to the total income, and that the present method operates more satisfactorily.

It was also pointed out that the present provision in the Wisconsin law to the effect that sales are considered to be made in Wisconsin if made through or by offices located within the state, might be interpreted in such a way as to raise constitutional doubts.[82] That if the words "through or by" are taken literally, Wisconsin would be attempting to include many sales actually made in other states, but that fortunately in the present application of the statute a sale is treated as being made at the place where the actual contract is closed.

The segregated or separate accounting method, it is stated in the Wisconsin Income Tax Regulations, should be used in preference to the apportionment method when the nature of the business will permit.[83] While there are many difficulties encountered in the operation of an apportionment fraction, the difficulties met in the use of the segregated method are generally as great or even greater. Sales, cost of goods sold, and certain expenses must be kept in separate records. Nor is the problem of overhead avoided, for the items making up overhead must be allocated and possibly on a variety of bases. Some of the items and bases suggested in the regulations are:

Overhead	Wis. sales to total sales or Direct cost of material and labor in Wis. to the total
Federal income taxes	Wis. income to total income
Interest paid	Wis. tangible property to total tangible property

Interest, dividends, and rentals received on investments in general are not subject to allocation. Related expenses are applied against these items of income and the net income is then taxed according to the situs of the property or the residence of the recipient.

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80 230 N. Y. 48 (1920).

81 Three Common Constitutional Misconceptions of Income Tax Law, Frederic Sammond, 8 Wis. Law. Rev. 199 (1933).

82 Cited in Note 81, supra.

83 Article 602.1 p. 171 (1931).

SUGGESTED REMEDIES

A great deal of thought has been given to the problem of apportionment of taxes between states by various committees appointed by the National Tax Association. Many valuable suggestions have been made from time to time and reported in the bulletin of this organization: The Proceedings of the National Tax Association. It is unfortunate that states have been slow to act on many of the suggestions.

As early as 1922 a committee reported that:

> It is essential to have a uniform method of apportionment in all states and, hence, a compromise system must be worked out. No correct method can be devised, as all results will be arbitrary. The committee recommends that a uniform mathematical formula for the apportionment of the net trading profit be incorporated in the statute of each state. Such a rule must consider both property and business, and the committee recommends a fifty-fifty basis, only tangible property to be considered. The business factor should be measured by the sums paid out by the taxpayers for wages, salaries, and purchases, plus the amount of the receipts from the sale of the goods and products dealt in.[84]

The committee gave equal weight to two main elements, property and business. Property was represented by the tangible capital invested, and business was measured by four items: wages, salaries, purchases, and sales. This fraction was approved of by very few states.

Another committee reported in 1926. The difficulties involved were well put by this committee in the following language:

> The incorporation of companies in various parts of the country has given rise to many difficult problems. The so-called "spawning states"—those in which corporations are organized but in which they do no actual business—have by their allurements, complicated the situation. Where is the domicile of a corporation that has a charter from Delaware, an executive office in New York, a plant in Pennsylvania and a principal sales office in Chicago? Its principal office, technically, is in Delaware but to call that state the state of domicile is the purest fiction.[85]

Those states in which the principal business of a corporation is carried on may by statute, such as that in the Wisconsin law which we have already considered, treat the company as being a domestic corporation for taxation purposes. As pointed out above, it is not known how these statutes will fare in the courts, and there are other questions involved too.[86] And, using the illustration cited, these statutes can have no effect on the taxing powers of the State of Delaware, nor do they solve the problem of what tax New York is entitled to because of management, or Pennsylvania because of the manufacture, or Illinois because of the sales made in Chicago.

The 1929 report of the committee[87] set forth four results which should be accomplished by the ideal apportionment fraction, and these may be summarized as follows:

1. All states should use the same fraction. Uniformity is essential if double taxation is to be avoided.
2. The fraction must include sufficient factors to make the results as accurate as possible in order to be acceptable by all states.
3. The fraction must be easy to determine in order to save time and expense for both the taxpayer and the state.
4. The fraction must not run counter to any of the provisions of the Federal Constitution.

The report also contained a summary of the various fractions that were then in use by the different states.

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[84] Page 128 Blakey's Digest and Index. Report of Committee on the Apportionment of Taxes between States, xv 198–215–222 (1922).

[85] Page 158, 1926 Proc. Nat. Tax Ass'n. Report of Committee on Simplification of State Taxation of Business Concerns. C. W. Gerstenberg, Chairman.

[86] e.g. What is meant by the principal place of business? In a bankruptcy case it was said:

"... the words 'principal place of business' imply that there may be more places of business than one, and call for the principal—i.e., the most important—of such places. This would indicate that what is had in mind is a place where business is actually done or transacted, rather than a place from which business is supervised, directed, or controlled." Roszell Bros. vs. Continental Coal Corp., 235 Fed. 343, 357 E. D. Kty. (1916).

Above affirmed in Continental Coal Corp. vs. Roszell Bros. C. C. A. 6th Cir. (1917). "But we think the place where the principal office is located is not necessarily the place where the principal business is carried on."

[87] Report of Committee on Standardization and Simplification of the Business Taxes. C. W. Gerstenberg, Chairman. 1929 Proc. Nat'l. Tax Ass'n. 152.

A very full report was made by the committee in 1931. While it recognized the fact that the fractional apportionment method gave results which are only approximations to the truth, it pointed out that separate accounting is subject to the same criticism. When goods are shipped to a branch or a subsidiary company where separate accounts are kept, certain values must be assumed and the amount of the overhead and other items that should be included can be determined only by use of some allocation scheme. It was stated that according to the testimony of experienced accountants, separate branch and subsidiary accounting is impracticable in the majority of cases.[88] The committee's recommendations are very well summarized in the following paragraph:

> While separate accounting may be in some cases the most accurate method of apportioning income, it is too expensive and cumbersome in most cases for the taxpayer to be the prescribed method; that a fractional method prescribed by the statute uniformly for all businesses is likely to be the most satisfactory, and that in the absence of a voluntary system of separate accounts that undeniably fairly reflects income attributable to a state, the statutory fraction should be the primary method established by law; that this primary method cannot be forced upon the taxpayer if it is unreasonable in an individual case, even though its general principle is reasonable; and that under restrictions that place some burden of proof on the tax commissioner, he should be given the option to show that an application of the fraction in an individual case will yield a tax below that to which the state is reasonably entitled.[89]

Many of the principles set forth above were ably discussed a year later by William S. Elliott who pointed out the advantages in the use of fractional formulas. This was on the assumption, however, that all states use the same formula for it was his opinion that separate accounts even though much more expensive to maintain, were preferable to the present overlapping formulas. He further stated:

> There can be no progress in any direction until the states recognize the present deplorable situation and agree to adopt uniform methods, in which case it will be just as easy to adopt a uniform formula as separate accounting. Fractional apportionment, I believe, should be the primary method for apportionment of ordinary business income, and separate accounting the supplemental method to be resorted to in special cases; and I might add that there will be far fewer special cases if and when the states adopt some uniform, well-balanced formula.[90]

Various other suggestions and proposals have been made at different times. One plan would distribute net profits in proportion to the expenses incurred in each state involved.[91] The capital investment would be converted into terms of current charges by means of a selected interest rate. For example, a rate of 6 per cent applied to an investment of $1,000,000 would give $60,000 and would be equivalent to actual outlays made during the period amounting to $60,000.

Roswell Magill believes that an arrangement might be made, perhaps through a crediting device, whereby the Federal Government would collect all taxes on the income of corporations doing interstate business and then make an apportionment to the states.

> So long as the states collect taxes on corporations doing business in several states, some inequalities in apportionment and administrative difficulties are inevitable. If these taxes were collected by the Federal Government exclusively, the corporations would profit from a simplified system, and multiple taxation would be eliminated.[92]

Others have thought that the solution may be in the Federal incorporation of companies

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[88] In Article 602.1 of the Income Tax Regulations of Wisconsin, 1931, page 173, it is said: "As a general rule, the separate or segregated accounting method is not considered as reflecting the correct taxable income for Wisconsin in the case of manufacturing business carried on both within and without the State." This method may be used by manufacturing businesses only in exceptional cases.

[89] Allocation of Business Income. C. W. Gerstenberg for the Committee 1931 Proc. Nat'l. Tax Ass'n. p. 311.

[90] 1932 Proc. Nat'l. Tax Ass'n. p. 206.

[91] Elimination of Double Taxation of Corporate Net Income. M. S. Howard. 8 Nat'l. Tax Mag. 329–331, 1930. Reprinted in full in C. C. H. 1931, p. 985.

[92] Cited in Note 18, supra., page 255.

engaged in interstate commerce.[93] It seems that Congress could pass such an act without a constitutional amendment. For example, it has been decided that the "regulation of commerce" clause in the Constitution has given Congress the power which it may exercise through a corporation, if it sees fit, to construct a bridge for the accommodation of interstate commerce;[94] and to build railroads across the states.[95]

The problem of apportionment would be eliminated if the major change be made in our income tax laws which some recommend. It is their theory that the tax on the corporation itself should be discontinued and that the assessment be made directly against the stockholders for the amount of the corporate income. The tax would be collected in the states in which the stockholders resided, in accordance with the general rule as to income from intangibles. The amount of the tax for any one stockholder would be determined by his distributive share of the net profits, in much the same way that individual partners are now taxed for their share in the earnings of the firm. It does seem illogical that business should be taxed in one way if carried on under the corporate type of organization, and in an entirely different way if carried on under the partnership form. Our present income tax laws do discriminate against the corporation. However, it is believed that there is little likelihood that the states will surrender their right to tax corporations. The revenue secured from corporations is too great to give up, and it would be difficult to obtain if from other sources. Many states feel that they have a right to tax the income produced from business transacted within their borders, irrespective of the residence of the recipients of the income. If, however, the business of corporations is to be taxed, to be consistent the business of partnerships and sole proprietors should also be taxed. This was recognized as early as 1919 and was expressed at that time in the third of three fundamental principles which should underlie a model system of state and local taxation. These principles as submitted by the committee of the National Tax Association are:

1. The first is the principle that every person having taxable ability should pay some sort of a direct personal tax to the government under which he is domiciled and from which he received the personal benefits that government confers.
2. That tangible property, by whomsoever owned, should be taxed by the jurisdiction in which it is located because it there receives protection and other governmental benefits and services.
3. The third principle, somewhat less clearly and generally exemplified by our tax law but discernible nevertheless, is that business carried on for profit in any locality should be taxed for the benefit it receives.[96]

Taxation of all business, no matter by what type of organization it is carried on, as recommended in the third principle, would tend to eliminate some unjust multiple taxation. As a great deal of interstate business is conducted by corporations, and as some states tax corporations which they have created on the theory given in the first principle while other states are taxing the same corporations on the theory that they are making possible the profits earned, it means that income from interstate business is particularly subject to double taxation.

These three principles have been cited with approval a number of times by authorities but little has been done with respect to the third one.

It has been stated that it is of greater importance that all states use the same allocation fraction than that the fraction be

[93] Cited in Note 85, supra.

Federal incorporation has been urged for other purposes. "Where each of the forty-eight states has its own particular method of chartering corporations there is, of course, a lack of uniformity in such important matters as capitalization, duties and qualifications of organizers and directors, objects of incorporation, and in the powers granted.

What is needed is a federal statute dealing thoroughly and systematically with the promotion, organization, and management of corporations engaged in interstate commerce." *Outlines of Economics*, Richard T. Ely. Fifth Edition. Macmillan Co. 1931, page 581.

[94] Luxton v. North River Bridge Co., 153 U. S. 525, 14 Sup. Ct. 891; 38 L. Ed. 808 (1894).

[95] California vs. Central Pac. R. Co., 127 U. S. 1, 8 Sup. Ct. 1073, 32 L. Ed. 150 (1887).

[96] Report of the Committee Appointed to Prepare a Plan of a Model System of State and Local Taxation. 1919 Proc. Nat'l. Tax Ass'n. page 426.

strictly accurate. Very little progress has been made, however, in getting the states to adopt exactly the same fraction. It is doubtful if the states will get together of their own accord, and for that reason some believe that the Federal Government should allow a limited credit against its tax where the state tax is calculated by means of an approved method of apportionment in the case of corporations doing interstate business. Such a step might bring about much uniformity and simplification.

CONCLUSION

A general income tax constitutes the only certain means by which a state may reach the profits made in interstate commerce. Some provision must be made in state income tax laws for allocating the profits. Where the nature of the business permits and where accurate records are kept, the taxpayer is usually allowed to report on the basis of separate accounting. The method most widely used, however, is that of general apportionment fractions. As more and more states adopt income tax laws, it becomes increasingly important that the same fraction be used by all states if unfair double taxation and unnecessary expense are to be avoided. That fraction should contain enough items to be as accurate as possible without being too complex. It must be reasonable, made from facts normally recorded, easy to apply, and constitutional. Little uniformity has been achieved and progress in this direction is apt to be very slow if present conditions continue.[97] It is submitted that the Federal Government could improve the situation greatly by allowing certain credits where a uniform fraction is used, or by the Federal incorporation or licensing of corporations engaged in interstate commerce.[98]

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[97] "There is, however, one formula which stands a fair chance of general adoption, namely, the Massachusetts formula. It has been used with general satisfaction to both tax payers and the state for over ten years. Five states have already adopted it, and six others are using fractions which do not differ greatly in result." Ralph Coughenour Jones. "The Campaign Against Double Taxation" Sept. 1934 *Journal of Accountancy* 198, 207.

A good summary and discussion of the different fractions used by states is given in an article on the "Allocation of Corporate Net Income for Purposes of Taxation" by Joseph Wallace Huston in 26 Ill. Law Rev. 725 (1932). Tables of fractions are also given in the following:

Report of Committee on Standardization and Simplification of the Business Taxes. C. W. Gerstenberg, Chairman. 1929 Proc. Nat'l. Tax Ass'n. 152.

State Taxation of Interstate Income of Manufacturing Corporations. Mabel Newcomer 1929 Vol. 15 Nat'l. Tax Ass'n. Bulletin p. 10, 11.

The Status and Certain Tests of Uniformity in Allocating Corporate Income. Robert S. Ford 1932 Vol. 17 Nat'l. Tax Ass'n. Bulletin p. 96, 97.

State Income Taxes II, National Industrial Conference Board, 1930, pages 113–116.

State and Local Taxation of Business Corporations, National Industrial Board, 1931, pages 80–81.

[98] The Federal Trade Commission recently had printed A STUDY OF, AND ASSEMBLY OF PROPOSALS FOR, AND OF VIEWS FOR AND AGAINST FEDERAL INCORPORATION OR LICENSING OF CORPORATIONS, as Exhibit 6083 of Part 69-A of Senate Document 92 (70th Congress, 1st Session). The report covers 143 pages and consists of official expressions, congressional bills proposed, party platforms, personal expressions of prominent individuals, views of the press, and actions by various organizations.

DEPRECIATION AND SAVINGS

H. G. KIMBALL

ACCOUNTING for depreciation is in itself a procedure whose desirability is now generally considered to be unquestionable, and for the moment I am willing to accept that estimate of it. However, I do wish to challenge the desirability of the financial policy which fathered the procedure. It appears to me from consideration of the accounts of several bankrupt enterprises that the results of the policy have in the long run been productive of more harm than good, that by obscuring certain considerations relating to saving, it has led to losses which might otherwise have been avoided, and that it may therefore be wise to discontinue it.

A policy, of course, must be judged by comparing the results which it actually

achieves with those which were expected of it. The policy of accounting for depreciation was designed to accomplish the maintenance intact of the capital sum invested in an enterprise by preventing its impairment through the distribution of dividends to the full extent of profits computed without regard to the diminution of the value of its capital assets as the result of wear, tear and obsolescence. The policy was imposed upon corporations doing business for profit by courts acting at the insistence of creditors determined to enforce financial policies which would afford them maximum security for their credits, and investors anxious to guard against being deceived as to their own financial position by the return of their savings in the guise of income. Both were seeking to preserve the capital upon which each depended for security.

The purpose of the policy is accomplished by reducing the amount of funds otherwise available for distribution to stockholders by an amount estimated to be necessary to made good the diminution of the value of the capital assets. The accounting entry is simple: a debit to profit and loss and a credit to the reserve for depreciation—or to the reserve for depreciation, obsolescence and other revaluations, depending upon the various factors which may need to be taken into account in any particular case. The charges to profit and loss show year by year the amounts withheld in respect of each year's operations; and the balance of the reserve, leaving out of account for the moment, adjustments for assets retired or written off when fully depreciated, shows the accumulated amount of funds withheld.

I know that this conception of the reserve for depreciation has been severely criticized, but nevertheless it is a popular view and I believe that at least in this matter the popular view is not altogether incorrect. An example from an engagement which I worked on last winter will illustrate it. A coöperative each year had returned to its members all the excess of the amounts charged for services over the cost thereof, including in the cost a provision for depreciation. About 1933 it became apparent that they would soon have to replace substantially all their machinery and equipment, and they had no cash in their treasury with which to do it. In prosperous times the financial problem might not have led the members to question the management as importunately as they did, but 1933 was not prosperous. The members pointed out to the management that each year it had withheld funds in respect of depreciation and that the reserve for depreciation showed a substantial balance. "Where," they asked, "is the money?"

It was easy to answer the question. The balance sheet of the coöperative was somewhat as follows:

Assets	
Current and working assets, net	$30,000
Capital assets	60,000
Total assets	$90,000
Liabilities and capital	
Reserve for depreciation	$50,000
Capital stock	40,000
Total liabilities and capital	$90,000

It was apparent on the face of the balance sheet, and the appearance was borne out by further analysis, that most of the funds withheld in respect of depreciation had been invested in additions to capital assets. The members were satisfied, and set about looking for the necessary new funds in other directions.

It will be noticed immediately that accounting for depreciation is significant financially only where there are profits before depreciation. If there are no profits before depreciation, there are no funds for distribution anyway and recording an entry with respect to depreciation has absolutely no practical effect on financial policy. True, such an entry is necessary to state the full extent to which capital has been impaired as a result of operations, but to state that is merely to emphasize a fact that is already stated unpleasantly enough.

The function of the reserve for depreciation as a measure of the amount of funds withheld in respect of the depreciation of capital assets is, of course, seldom fully developed. The reason is, briefly, that the reserve is seldom funded. And when it is not,

there is always the problem of tracing the disposition of the funds withheld in respect of it. In tracing this disposition it is useful to distinguish with regard to their capitalization, two categories of enterprises, those whose fixed capital has been obtained principally from funds returnable to the investors at fixed maturity dates and those whose fixed capital has been obtained principally from funds permanently invested.

As an example in the first category assume an enterprise organized with a capital of $2,500 invested in working assets and a $10,000 plant with an estimated useful life of 10 years purchased with the proceeds of 10 year sinking fund bonds. Its balance sheet at the date of its organization would be as follows:

Assets	
Capital assets	$10,000
Working assets	2,500
Total	$12,500
Liabilities and Capital	
Ten-year sinking fund bonds	$10,000
Capital stock	2,500
Total	$12,500

Assume that it has operated ten years, just broken even on operations after providing for depreciation, met its sinking fund requirements of $1000 a year and has not expanded. At the end of the ten years its balance sheet would look like this:

Assets	
Capital assets	$10,000
Sinking fund assets	10,000
Working assets	2,500
Total	$22,500
Liabilities and Capital	
Ten-year sinking fund bonds	$10,000
Reserve for depreciation	10,000
Capital stock	2,500
Total	$22,500

The disposition of the funds withheld in respect of depreciation is plain. They are in the sinking fund, available for retirement of the bonds. Liquidation would be easily accomplished; and, on the other hand, if it were desirable to continue the enterprise, the problem of financing the purchase of new capital assets would likewise be clear.

As an example in the second category, assume an enterprise organized with a capital of $25,000 all obtained through the sale of capital stock, invested in a plant costing $15,000 and working assets amounting to $10,000. The following statement is a summary of its financial condition at the date of its organization:

Assets	
Capital assets	$15,000
Working assets	10,000
Total	$25,000
Liabilities and Capital	
Capital stock	$25,000

Assume that this plant also had a life of ten years and that the enterprise has operated for ten years without expanding, just breaking even on operations after providing for depreciation. The balance sheet at the end of the period follows:

Assets	
Capital assets	$15,000
Working assets	25,000
Total	$40,000
Liabilities and Capital	
Reserve for depreciation	$15,000
Capital stock	25,000
Total	$40,000

Here again the disposition of the funds withheld in respect of depreciation is easily discovered. They comprise part of the working assets.

These two examples should be sufficient to illustrate the relationship of the reserve to financial policies designed to preserve intact the capital of an enterprise. Of course, in practice problems are not so simple because, as mentioned above, the reserve is seldom funded. However, even when it is funded, if the financing of additions are carefully distinguished from the financing of replacements, practical problems are not more difficult than those presented by the fore-

going examples. A more complicated problem involving accounting for depreciation reserve funds may be illustrated by the following summary of transactions affecting capital assets during a year:

	Capital assets	*Depreciation reserve*	*Depreciation reserve fund*
Balance at beginning of period	$50,000	$25,000*	$25,000
Depreciation for period, charged to profit and loss account		5,000*	
Funds appropriated in respect of depreciation for period			5,000
Assets retired, fully depreciated	2,000*	2,000	
Assets replaced with funds from:			
Depreciation reserve fund	2,000		2,000*
Working capital	1,000		
Additional assets purchased from new capital funds	10,000		
Balance at end of period	$61,000	$28,000	$28,000

* Denotes credit.

In the example above I have assumed as a basis for the accounting that net additions to the investment in capital assets are financed out of funds other than depreciation reserve funds, and that the latter are used only to the extent that they are applicable to the particular items replaced. As a result, the amount of the reserve and the amount of the funds have remained equal to each other. But the relationship between the two need not have been lost even if, for example, the net additions to capital assets had been financed out of the depreciation reserve funds reducing them to $17,000. It could have been preserved in a balance sheet, as follows:

Assets		
Depreciation reserve fund:		
Amount applicable to assets in service as measured by reserve, per contra	$28,000	
Deduct: Amount invested in additions to capital assets	11,000	
Balance		$17,000
Liabilities		
Reserve for depreciation		$28,000

How is the financial policy—the retention in the enterprise of funds withheld in respect of depreciation—which is illustrated by the foregoing examples, related to the process of savings? And how may it lead to losses when it was adopted specifically for the purpose of avoiding them?

The answers depend, of course, in part upon the nature of the process of saving. The process when it does not consist of sterile hoarding takes the form of investment in some enterprise. It is not completed with the initial investment. It must be repeated each time when as a result of the operations of the enterprise the funds invested in capital assets are returned to liquid form. Each reinvestment affects the safety of the savings.

In the example of the enterprise whose assets were purchased with the proceeds of the sale of bonds, the funds withheld in respect of depreciation were deposited in the sinking fund for retirement of the bonds. Upon being returned to the bondholders, the funds, if reinvested, would be reinvested by the persons who owned them. The interest of the owners, their desire for security, would tend to lead them to look about before reinvesting, to investigate all the industries and all the particular companies seeking capital. It is probable, if their investigation was intelligent and thorough, that they would invest in rising or expanding industries with prospects of profitable operations for at least as long a period as would be necessary to realize from operations the funds placed in capital assets. By doing so they would assure themselves safety for their savings and frequently at the same time perform the larger social function of withdrawing their funds from a decadent industry and placing them in a new and vigorous one. The old would die with a minimum of loss and the new would develop with a maximum of facilities.

On the other hand, in the example of the enterprise all of whose assets were obtained out of proceeds of the sale of capital stock, the funds withheld in respect of depreciation constituted current assets of the enterprise which the management could dispose of for any proper purpose which in its judgement

it would be desirable to pursue. Management is under no obligation to return such funds to the persons who in effect own them; it may reinvest them itself in the business in which it is engaged, and observation discloses that in most cases that is precisely what it does. So long as the industry is profitable and the particular company is well managed no harm results. But when the industry declines—as, for example, coal, the railroads and the merchant marine—automatic reinvestment is harmful. It freezes the savings of investors in unprofitable enterprises to be wasted by operating deficits, and hampers the development of new industry by preventing savings from freely flowing to them. Not least, a dying industry's efforts to survive give rise to harmful competitive practises including wage cutting and other unsocial labor policies. The old dies with the maximum of loss to both investor and society, and the new develops with a minimum of facilities.

It is apparent, then, that the policy of withholding from the investor that portion of the revenues of an enterprise which may be fairly considered to represent the realization of its capital assets is harmful. It results in the dissipation of savings instead of their preservation as it was hoped to do. It has been based upon the tacit assumption that any well-managed enterprise will continue to profit and to grow indefinitely and will consequently offer a continuing opportunity for profitable investment. On the contrary, experience has taught that while industry as a whole may expand—of course, certain economists deny that it may be expected to expand indefinitely, or even to maintain itself as we know it—industries, and especially particular enterprises, die faster than we like to think. New ones, of course, are born, and the principal problem of preserving savings becomes the problem of reinvesting them profitably, of transferring them from the dying to the growing industries. If this is to be solved successfully—and there are plenty of reasons to doubt that it can be solved—the way to do it seems to lie in the direction of restoring a freer flow of capital and of developing alertness and intelligence in investors. Such a development can be accomplished only if automatic reinvestment is eliminated, and the responsibility for the investment of savings thrown back upon their owners, who, being sure to suffer for their bad judgements, have every reason to be alert and intelligent. Therefore, if we earnestly desire to solve the problem of keeping savings safe, we must give new thought to automatic reinvestment, and once satisfied that it is harmful, move to discontinue it.

A movement to abandon the policy which underlies automatic reinvestment would, of course, meet strenuous objections, not the least of which would be the complaint that it would hamper a management's efforts to develop the enterprise in its charge. I think that such a complaint could be put down as in part the protest of a vested interest being deprived of a good deal of its power—the power of directors to determine what dividends may be paid, what funds retained and how they may be used—and in part the demonstration of a lack of confidence on the side of management. I think the protest is presumptuous and the lack of confidence unjustified. Any management that could offer a convincing prospect for profitable investment of additional funds would have no great difficulty in obtaining them. It is true that, as a result of abandoning the policy, management would have "to go to the people," that is, to its stockholders, on decisive issues more often than it now has to, but I cannot help but believe that more real democracy in the government of corporate affairs would be beneficial to both the investors in our several companies and to society in general.

STANDARDS: A DIALOGUE

E. L. Kohler

Place: *The living room of MacMurdie's home, City of Zenith*
Time: *Yesterday evening*
Personae:

JAMES H. MACMURDIE, *middle-aged, born and educated abroad.*
FREDERICK BENDER, *his partner, ten years younger, an American product.*
AUGUSTUS BARDLEY, *professor of accounting at Zenith University.*
AUSTIN J. PARSONS, *an accountant-in-charge, employee of MacMurdie, Bender & Co., Certified Public Accountants.*
FORREST FENWICK, *a junior accountant, recently graduated from Zenith University and newly certified, likewise an employee of the MacMurdie firm.*
SEVERAL ACCOUNTANTS, SENIORS AND JUNIORS, *members of the firm's staff.*

Bender: Now that the cockles of our hearts have been warmed by this hickory fire, we might well proceed to the real business of the evening . . . Perhaps I should say for the sake of those here for the first time that our fortnightly forgatherings have as their object a full and free discussion of anything and everything pertaining to accounting. Occasionally we invite persons other than firm employees to sit in with us. Tonight we have Professor Bardley.

MacMurdie: I assume everybody knows Professor Bardley.

Bender: A good deal has been said recently about standards for accountants. This morning Parsons and I had occasion to examine a recent publication entitled *Financial Reports for Colleges and Universities.* This book reflects probably the first attempt in the history of accounting to produce a coordinated, closely integrated textbook of standards, notwithstanding the fact that it covers a specialized field.

MacMurdie: But what about the hundreds of uniform systems of accounts that have been produced since Professor Adams' pioneering in railway accounting?

Bender: That's a fair question. There have been many uniform systems of accounts put out by our public-service commissions, the I. C. C., and a pretty good number of trade associations. Most of them have dwelt extensively on account classifications and how and what to debit and credit. Most of them include provisions for some sort of financial statements. But none of them have gone so far as Chapter II of the book I just mentioned. That chapter rehearses the principles, 24 of them, anyway, of institutional accounting; it contains also the definitions of 73 terms employed in succeeding chapters along with quite a list of correlative terms.

Parsons: We did not agree with all the definitions.

Bender: True. At this stage in the development of accounting, it would be difficult to frame definitions that everybody would agree to. It's the courageous effort to lay down a reasonable set of standards that I applaud.

MacMurdie: What are you trying to designate as "standards"? Perhaps that word in itself needs defining. Do you mean an arbitrary selection of rules governing the maintenance of the accounting records, plus a batch of definitions?

Bender: I knew this question would be raised and I brought along Professor Bardley to help me. Bardley and I have had countless arguments on the subject and he has some pretty positive ideas that he proposes passing on to you. In our talks we have never defined "standard."

Bardley: Indeed we have not. Nevertheless, we have progressed rather far in our discussions by assuming, I suppose, that our ideas on the word have not been at variance. It is remarkable to what lengths arguments between two persons can go without a clear formulation of assumptions by either. Argu-

A paper presented at a meeting of the Wisconsin Society of Certified Public Accountants at Madison, October 18, 1935.

ments in specialized fields like accounting are apt to be fruitless because observed phenomen quickly become the dominant topic. They lead away naturally from abstractions because we are less concerned with abstractions in our daily work. If we are to discuss principles we might best do so by following an *a posteriori* method. Our conclusions will thus be more nearly and more clearly related to our facts.

MacMurdie: But the definition.

Bardley: A standard is merely an accepted rule. The rules which offhand you and I might invent are not rules which would be at once adopted by all accountants or even by a majority of them. As Mr. MacMurdie from his long experience can doubtless testify, much propaganda would be required before their acceptance by any substantial group, and in the end the national associations would probably have to legislate them into existence. That would be using force in their adoption.

MacMurdie: But wouldn't that destroy their value as standards?

Bardley: Not merely because something beside powers of persuasion had been employed. Nor would it follow that approval by national organizations would automatically create them. Acceptance and actual use by a significant majority of accountants would have to occur first. But action by national organizations would emphasize their need and might hasten the trend in the direction of a reasonable body of standards, if only through the inevitably constructive character of destructive criticism.

MacMurdie: It looks as though you would favor standards of some kind in accounting, Professor Bardley, although you have not said so directly. Why?

Bardley: Most certainly I favor them. I have never agreed with the report of a certain committee of accountants which just four years ago in rejecting a proposal for the classification of accounting services made a statement to the effect that anything that would restrict original initiative and thought by accounting practitioners even "in the slightest degree" would be most harmful. The instinct of self-preservation is commendable. Were all accountants of a high moral caliber and possessed of a vision so transcending the ordinary human being's that their acts would result in the greatest good to all men, nobody could have cause to complain. But accountants, being unable to escape the classification of human beings, are motivated sometimes by the baser desires—venality, for instance—and, as a body, would not be content for long to dwell in the empyreal state of anarchy for which this committee report contends.

MacMurdie: Of course we will all grant that as citizens or as accountants we could not endure anarchy. I believe in national organizations because they represent in a general way a getting together of the profession—not to mutually curtail each other's activities but to behave as gentlemen to one another. If we do that I cannot see how any anarchy within the profession can be said to exist.

Bender: By anarchy I think Bardley means absence of government or of a strong controlling force over the profession.

Parsons: Professor Bardley, I would like to have you expand a little on the idea of having standards. You spoke of beginning with specific things and going back to the more abstract. Can you give us an illustration?

Bardley: With pleasure. I have a number of things in mind, one of them called to my attention today in a letter from Anson Herrick. Mr. Herrick, as you may know, has written a good deal about working capital. He read a paper on the subject several years ago at an Institute meeting in which he presented some extremely pertinent though unconventional points of view. On one matter he was unusually insistent: that prepaid expenses can properly be regarded as current assets. It seems that recently he has had some words with Professor Sanders of Harvard on the allegedly undiscriminating treatment of prepaid expenses by the Securities and Exchange Commission. On Forms A-2 and 10 and related forms the Commission lumps together both deferred charges and prepaid expenses.

Parsons: Item 16 on both forms: practi-

cally the last thing on the asset side of the balance sheet.

Bender: We practitioners have had two reasons for looking at prepaid expense as a noncurrent item: first, it cannot as a rule be converted into cash, and second, everybody treats it as belonging to the category of deferred charges. Our first reason is, of course, unsound because when the item consists of unexpired insurance premiums and the like it is a recurrent expenditure common to all enterprises and therefore as much a part of cost as merchandise itself.

Bardley: That is true. Much the same argument is made by Mr. Herrick. He looks upon a disbursement for an insurance premium as the payment for a service not yet rendered. But it will be rendered within a year and by virtue of that fact it may be more of a current asset than a part of the inventories or some of the accounts receivable.

MacMurdie: Would conservative banks and bankers stand for the inclusion in current assets of something that is a claim on future services rather than cash, a claim on cash, or a physical object that can be converted fairly readily into cash?

Bardley: Mr. Herrick has anticipated that objection. He says that if we gave expression to the allegedly conservative views of all the bankers we might have nothing left under the heading of current assets. He says further, "I don't think that the banks should be looked upon as determinative of accounting principles."

MacMurdie: You are now fairly close to a subject concerning which there appears to be two distinct schools of thought. On the one hand we have accountants who say that the profession must have the concurrence of high authority upon adopting any "rules or principles" and that one hope is the Securities and Exchange Commission with whose assistance such "rules or principles" may be formulated. On the other hand we have the accounting radicals who advocate that accountants should not only think for themselves but also formulate their own rules without reference to outside agencies. Bankers may not be the proper persons to establish our procedures but their agreement to any departure from well-established past practice would be quite essential to our relations with them.

Bardley: Many accountants appear to be fearful of what others may think if the profession should ever assert itself. An outsider would likely call such a position cowardly, but I am inclined to think that it arises from causes of a less obvious nature. The accountant with a dozen years of hard experience behind him knows that the same set of conditions are often resolved in a number of ways. He tends to regard the individual with but one solution as failing to distinguish between theory and practice. Actually, the difference lies between a conclusion traceable to well conceived postulates or universals and conclusions which vary because the selection of premises leading to them has been allowed to remain in the hands of others.

Bender: To that oversimplified individual, the man in the street, the honesty of the accountant can be questioned if he cannot be depended on to react in the same way to identical chains of circumstances. I am perfectly willing to grant your implied charge that accountants have not succeeded in being the independent persons they are often believed to be. Not all of them are agreed that they should ever be independent except perhaps in some remote and intangible way. To emphasize that fact I should like to read an excerpt which I made today from a draft of a proposed new edition of the Federal Reserve Bulletin which I am told the American Institute of Accountants is planning to publish before the end of the year:

> [reads] Financial statements must necessarily be largely expressions of judgment, and the primary responsibility for forming these judgments must rest in the management of the corporation . . . if the conclusions reached by the management are, in his [the accountant's] opinion, manifestly unsound, he is not entitled to substitute his judgment for that of the management (1) when the difference is not of major importance, (2) when the management's judgment is not unreasonable, and (3) when he has no reason to question its good faith. [ends reading]

MacMurdie: With that sentiment I find myself fully in accord. As accountants we have no license substituting our judgment for our client's. We don't build up the accounts: we take what we find, and if it appears too sour we qualify our certificate in suitable fashion.

Bardley: If we agree with the foreword which Bender has read to us, we must realize that the responsibilities of the profession are, indeed, not what the layman has imagined them to be. Before the depression we used to hear a great deal about the impartiality and detachment of practitioners. I wonder if these denials of professional independence are not in reality defense mechanisms arising out of the fear of unjust prosecution by blackmailing lawyers.

Bender: That may well be. They may also point to the sins of omission and commission which some accountants may wish to charge to their clients rather than to themselves because of the undoubted influence on final results for which clients, certain of them, anyway, have been responsible. In any event, I am inclined to think that they relate to past events rather than to those that we may look forward to in the future.

Bardley: Bender is an incorrigible optimist, but he has made a good point. I am afraid my pessimism suggests one thing more. A number of accountants recently took pains to inform a committee of the Pennsylvania legislature in effect that accounting is not a profession. That is a perfectly logical sequitur to the assertion that "high authority" must accompany the adoption of any new accounting rule.

MacMurdie: I should resent that remark, Professor, were it not for the fact that in your classrooms you must necessarily fail to perceive the practical approach to the business problems with which the practitioner, whether or not he be called a professional, must daily cope. I do not wish those of our staff here tonight to gain the impression that accounting is a cloistered subject which must remain on a high pedestal, nor on the other hand am I willing to see our leading practitioners dubbed, in practical effect, moral cowards or persons affected with venal motives. Our realistic, everyday world moves rapidly. If you will consider the limitations imposed on us not only of time but of scope and a hundred other things, our utter dependence on the forces surrounding us might become more apparent to you. We serve many masters, or, should I say, taskmasters. By the fact of the restrictions to which we are subject, our appeal for recognition and ultimate independence must rest on our integrity, our clairvoyance.

Bardley: On the matter of integrity we can heartily concur. Every trustworthy accountant must possess it to the nth degree. Yet integrity, and the honesty that goes with it, isn't everything. As old Sam Johnson put it, "hell is paved with good intentions." The criticisms which are conveniently heaped upon accountants from time to time cannot be ascribed wholly to cranks, persons seeking alibis, nor even to a public ignorant of the most elementary concepts of accounting; the blame rests on the accountant himself because he has never taken the trouble to tell the public, the courts and all others who seek to judge him precisely how he is circumscribed in his work. In Bender's quotation the implications are there, but to state them in any fundamental way would, of course, weaken the position of the profession.

Parsons: If the accountant would take the necessary trouble, we would have, I take it, a collection of standards. This brings us back to the point we started from.

Bardley: Yes; and in returning to the subject of the evening I have only this to add to our discussion of prepaid expenses: they are undoubtedly our best example of a perfectly good current asset gone wrong. But that reminds me of something else quite fundamental: the existing number of definitions of current assets, each supported by undoubtedly competent and high authority. Last year Fenwick, who I see is sitting near me, wrote a term paper that brought out these definitions. Do you recall them, Fenwick?

Fenwick: I believe I can recall four: first, cash, and other assets readily convertible into cash; second, cash, and other assets convertible into cash without interfering

with the normal operations of the business; third, cash, and other assets which will normally be converted into cash in the next succeeding year through the regular operations of the business; and fourth, cash, together with other assets likely to be converted into cash or more liquid assets, available for any use.

Bardley: It would be helpful, Fenwick, if you could summarize for us your arguments for and against these definitions.

Fenwick: I would like to talk from the fourth definition, as this was the one that seemed to fit the greatest number of cases as we observed them in annual corporate reports. First, we found that there was emphasis on the unrestricted character of any asset called current; that is, the cash finally realized must have been available for any purpose. Such items as cash which can be used only to purchase fixed assets were always excluded. The other three definitions are deficient on this point. Second in importance was the probable convertibility of an asset into restricted cash or any other more liquid current asset. Investments, though readily marketable, in practice do not appear to have been given a current-asset classification unless they represent a temporary investment of excess cash which so far as determinable at the balance-sheet date can be used for any purpose. Possibly "normal conversion," the term employed in the third definition, means the same thing but it does not seem as though it would allow the inclusion of readily marketable investments long regarded as noncurrent which may be expected ultimately to be converted at the current market price and used for working-capital purposes. Then, too, by inserting the words "or more liquid current assets," raw-material inventories would not technically be excluded in that the time consumed by manufacture and sale together might extend to more than twelve months.

Bardley: We may say, therefore, that the tests of a current asset other than cash are its probable conversion into a more liquid form and its lack of restriction upon conversion. I say "a more liquid form" rather than "cash." But this suggests another test for a current asset that Fenwick did not mention in his fourth definition; it has to do with the inherent nature of the asset. Current assets, like all other assets, aid in the production of income; at least they are acquired and held for that purpose. They are differentiated from capital assets only in a single particular: any one item such as inventories is being held for quick conversion, while machinery, also yielding services, will be converted as a whole into services only over a relatively long period of time. Time is thus an essential function of current assets that might deserve a separate listing. We may then paraphrase by saying that the distinguishing characteristics of a current asset are its availability, its convertibility, and the relatively short life of all the items making up that asset.

Parsons: Is the twelve-months' feature which I recall in Fenwick's third definition understood to be also in the fourth?

Fenwick: No; in many instances we found that the cycle of conversion extended to a period of several years, yet the practice is quite universal to include in current assets long-term receivables, and inventories which are even less liquid than long-term receivables.

Bardley: There are some exceptions to this practice but a great majority of enterprises selling some or all of their products on an instalment basis classify both receivables and inventories as "current" notwithstanding that the average maturity of the receivables may be well over a year. As I said a moment ago, time is a function of current assets; and this is illustrated in the fact that so much attention in merchandising businesses is paid to the ratio of sales to current assets as well as to the ordinary merchandise-turnover ratio.

Bender: In the statements just made about current assets there would seem to be nothing which in the slightest degree would exclude prepaid expenses. Items like insurance premiums and rent, if prepaid, answer the tests of availability, convertibility and short life. But is there not another aspect of current assets which we may have overlooked? Must not current assets, with the exception

of receivables, have a physical existence; that is, must they not occupy three-dimensional rather than two-dimensional space? Are they not in the nature of intangibles?

MacMurdie: I think I can answer that. Bardley has stated that all assets are held, or at least acquired, with the prospect that they will yield services. The service to be rendered by an account receivable is that of bringing in cash available for any corporate purpose. The service of inventories is to be converted into something more liquid which will include a gross profit. Insurance premiums render a service of protection from fire or other damage, theft and other unpredictable contingencies. Without the prospect of future services, assets have no value. Professor Bardley has helped to clear the picture but he has not helped to change the practice. Since prepaid expenses are so small a part of total assets, classification becomes a minor problem and I fear we shall have to follow what others are doing.

Fenwick: In our review of nearly 200 published statements, we found only three examples of prepaid expenses within the current-asset group. One of them appeared in a balance sheet to which a certificate of Lybrand, Ross Bros. and Montgomery was attached. Montgomery, in the latest edition of his *Auditing Theory and Practice*, holds that prepaid expenses are current assets.

Bardley: But in that group of 200 reports were several other Lybrand certificates. In those certified balance sheets, despite Montgomery's belief, prepaid expenses were classified in the conventional way.

MacMurdie: I have no doubt that theory differs from practice in many other situations. Bankers demand that current assets include only things they can lay their hands on in the event of an emergency, and so prepaid expenses are thrown out. Perhaps good theory says no; but we accounting practitioners must be hard-headed.

Bender: By throwing out prepaid expenses we are yielding to the banker, of course, and we are doing it with our eyes open. I will go so far as to say that this is bad practice because the theory of the balance sheet as it is ordinarily prepared embraces the going-concern concept. The assumption is that the business will continue its operations indefinitely. In yielding to the banker we yield to a partial liquidation point of view. But the truth of the matter is that a bank loan or maturing funded debt can't be paid with inventories or receivables any more than with insurance premiums, unless the business is to be wholly wound up.

Parsons: Yielding part way to the liquidating viewpoint reminds me of the argument we have every year with the First National Bank. One of our clients, Professor Bardley, is a publisher and at any moment of time he has not less than a hundred thousand dollars' worth of type metal on hand somewhere in his plant: in the linotype and monotype machines, made-up forms in or ready for the presses, or in "holdovers." Now the bank, which at certain times of the year makes temporary loans to our client, insists that we show the type metal as a current asset because, next to cash, type metal is our client's most liquid asset. It has a quoted market figure at all times and could be disposed of in total overnight. According to the tests you have laid down, who is right?

Bardley: Your practice, as you have inferred it, is most assuredly right. Type metal is not a current asset because on a going basis there is no likelihood of its being converted into cash. If any substantial portion were sold, your client would have to quit business. The bank's attitude is surprising in view of the fact that a temporary loan has as its purpose merely the tiding over of a peak period. The loan were better not made if there is any danger that regular current assets at the maturity of the loan will be insufficient to pay it.

A senior: I have a question I should like to put to the group. We have another client who objects to our showing the cash surrender value of a life-insurance policy as a noncurrent asset. Here again the argument seems to be that this asset is a very realizable one and he even wants it shown as a cash asset. We argue with him this way: there is no announced intention that the policy will be canceled during the coming year; therefore it is similar to any other permanent

investment account and is at present unavailable for working-capital purposes.

Bardley: Is there a loan against the policy? Would you change your solution to the problem if there were?

A senior: There isn't any loan but I believe if there were I would have to call the cash surrender value a current asset and the loan a current liability. This answer doesn't agree with any availability test for current assets but how could you show the loan as a current liability with the cash surrender value outside current assets?

A second senior: That's an easy one. Why not deduct the liability from the asset and show only the equity in the cash surrender value?

Bardley: As I see it, the question is one of classification only It is agreed that there is an asset and also a liability with that asset as security. Now the classification of balance-sheet items is dependent on the use to which the items are to be put within a short period of time following the balance-sheet date. I assume that everybody agrees to that proposition. With a loan outstanding against a life-insurance policy, is the disposition of the policy to be any different?

Parsons: It might be, because many loans will never be repaid and many policies will be canceled. Some corporate investors in life-insurance policies borrow up to the full loan value and they expect to make that a permanent feature of their holding of the policies.

Bardley: Intention has much to do with asset and liability classification. If your client has made one loan against a policy and is uncertain as to his future plans the accountant will probably have to take the position that the loan, like any other current borrowing, is a temporary one and therefore a current liability, while the cash surrender value remains a noncurrent investment. I can see nothing incompatible in a different classification for the asset and liability. Intent must govern. If, however, your client has followed the practice of borrowing each year against the increase in loan value of the policy, represents to you that he proposes to continue this practice and pays no interest on the obligation, I see no reason why the equity cannot appear under permanent investments. Only in so extraordinary a case should a liability be deducted from an asset.

Bender: Another question has bothered us during the last six months following a number of refinancings. A typical example is the long-term indebtedness of the Ajax Corporation. In March 1935 this concern floated at par a new issue of 25-year bonds and with the proceeds retired an equal par value of an old issue which would have matured serially to 1940. On the old basis the discount for the balance of 1935 would have been around $5,000 and the interest $45,000. On the new basis the interest is 20% less or $36,000. Unamortized discount at the time of reorganization was about $25,000 and because of meager earnings it was important from the company's point of view that proper consideration be given to its disposition. Four solutions were discussed. First was a charge-off of the full amount to profit and loss. Second was an amortization or the old discount as though the issue were still outstanding. Third was the continued amortization on the old basis as just mentioned, plus an additional amortization equal in amount to the savings on the new over the old basis. Fourth was a spread over the life of the new obligation.

Parsons: Any one of the four bases has some justifiable principle or other supporting it. It's all a question of the principle you select.

Bardley: I take it that you didn't decide on the first of these methods. To have done so would have meant that no recognition had been given to the continuation, for practical purposes, of the old obligation.

MacMurdie: That is the very point. The creditors were different because an entirely new issue was floated. Even the mortgage indenture had a number of features that the old mortgage had not contained. This fact was, however, overshadowed in importance by the purpose of the issue. After the transaction had been consummated, there was no more money in the bank than there had been before and the amount of debt which the company had to face in the future was also

the same. But by the act of refinancing, nearly $11,000 in interest was saved annually, less whatever discount on the old issue is figured against it.

Bender: I would like to draw some of our younger men into this. Fenwick, now that your schooling has been topped off by a year's practical experience and a C.P.A. degree, let's hear how you would dispose of this burning issue.

Fenwick: Well, it happens that we have talked over this problem in the staff room because it appeared in the last C.P.A. examination accounting-theory questions. George Foulkes, who stood highest in Zenith's graduating class this spring, claims this question caused him to fail in accounting theory, although he passed in the other sections of the examination, because he looked at the thing for over an hour without touching pencil to paper.

Parsons: Can it be that our accounting texts are silent on a point like this?

Fenwick: Yes; we've made a search and there's not a word anywhere on the subject, probably because refunding issues have not been common in industrial companies until now. But a number of us reasoned it out this way: the situation is analogous to that of a displaced asset. A machine is retired at the end of its fifth year of operation, although it normally would have lasted ten years, because it has been found that a cheaper machine or a faster or an otherwise more efficient machine will do the same job at a less cost. Probably the management weighs all the factors involved and in deciding to make the change takes into account the loss that will have to be absorbed because the machine is only half-depreciated. So far as I have been able to find out, the only practice countenanced by our office would require a charge-off in full during the year the displacement occurs. No one would think of carrying forward any of the cost of the old machine. And so we decided that none of the unamortized discount on the displaced issue should be carried forward.

Bardley: There is good common sense in that analogy. But it may be necessary to distinguish liabilities from assets.

Parsons: If the balance sheet and income statement have as their objective the showing of the residuum belonging to stockholders, isn't a liability just a negative asset? I have never been able to see why gains or losses on the retirement of liabilities should not be carried through the income account just as are gains and losses from retirements of capital assets.

MacMurdie: One good reason can be cited. A business enterprise doesn't recast its financial setup every year in the regular course of business. But probably no year passes without a premature retirement of some capital asset.

Bender: But should we necessarily be influenced by the regularity of transactions in our disposition of them?

MacMurdie: Certainly we should. The more unusual type of transaction illustrated by the refinancing is given a longer perspective than the everyday replacements of machines.

Bender: The automobile industry has just retooled and is now in production for the coming season. Some of the recent announcements bring out prominently that the retooling has cost millions of dollars. Shouldn't the unabsorbed cost of last year's tools be regarded as a cost of the new season's production?

MacMurdie: Retooling in the automobile industry is a seasonal affair. More powerful engines and new body styles are the products of competition. Any manufacturer who has failed to see these changes coming years in advance simply hasn't been alive to what has been going on in the industry. If he has been sensible, rather than greedy to make a showing, his reserves for depreciation and obsolescence will be large enough to absorb the losses from scrapping or rebuilding his last year's tools. I don't consider this situation analogous to the problem of refunding. No one could have predicted two years ago that money would be as cheap as it is today. Nobody could have planned for it, in fact, would have been called a fool had he started to write down his bond discount at an accelerated rate.

Bardley: Our thinking on this problem

might be helped a little if for a moment we looked into the nature of bond discount and expense. Parsons' comment on outstanding bonds brings out the interesting contrast that always exists between assets and liabilities. A liability is a negative asset in more than one sense. A liability is paid for when its utility (or should we say disutility?) has expired, while an asset is paid for at the time we begin calling it our own. Conversely, the cash yield of a fixed asset comes when we finally sell it for scrap or because of its inutility, while the cash yield from a debt is received at the moment it makes its appearance on our books. The difference between the cost and the yield in both cases we gradually absorb in profit and loss as the years go by. The reserve for depreciation, gradually built up during these years, we call a valuation account and we demand its deduction from the asset to which it is related. The unamortized bond discount and expense we gradually write down, over the life of the liability; but instead of calling it a valuation account we curiously enough call it an asset. At one time, as we all know, bond discount and expense were proverbially buried in the plant account and accounting students were busy pulling them out. We have made some progress since then, and the fact that our thinking with respect to liabilities has progressed no further is attributable to the fact already well brought out by Mr. MacMurdie: that transactions in funded debt are few and far between, especially refunding operations.

Bender: Perhaps the distance that still separates unamoritzed discount and funded debt accounts for our tendency to look at the discount as something having an entity of its own. Had we come to regard it as a debit valuation account, we would not be so perplexed now.

Parsons: Isn't a liability something a bit more realistic to the going concern than an asset? We can walk away from an asset and abandon it; the going concern would have difficulty in walking away from a liability.

Bender: I do not see that a going concern would abandon a liability even in part by carrying it on the balance sheet at somewhat less than its ultimate redemption cost. By proper amorization methods we are not failing to recognize the maturing liability.

Bardley: I am sure we have gone as far as we can in a discussion of this kind in getting at the essence of the deferred charge. There can be little justification for the continuance of the deferred charge except in so far as we recognize the practical identity of the old and the new issues. If the new issue clearly does not stand on its own bottom, as for example where the bondholders receive new bonds in exchange for old, a fairly obvious identity exists. By extension, such identity has come to include any refunding operation where the obligor never really has free use of the cash flowing from the new issue. I have found that condition attaching to the proceeds of all strictly refunding issues which I have had occasion to inquire into.

MacMurdie: We have reached the point where someone might try to pick one of the four methods of amortizing the old discount. I take it that no one approves the fifth method whereby the discount is absorbed in the plant account. In the Ajax case we continued the same rate of amortization of the old discount, thus giving practical recognition to the uninterrupted existence of the company's indebtedness to outsiders.

Bardley: Had there been a discount on the new issue would you have proceeded to amortize that in the regular way?

MacMurdie: Yes, because that would have been an additional burden imposed on the cost of carrying the obligation.

Bender: A premium on the new issue would also have been subject to independent amortization, I suppose, although we have had no cases where this point was involved. I still lean toward the third method: the one where in addition to the regular discount charged off we would also charge off an amount equal to the savings measured by the excess of the discount and interest costs had the old issue continued, over the discount and interest costs arising out of the new issue.

MacMurdie: That would be slightly more conservative because it would decrease the number of years; practically, the difference for balance-sheet and income-statement pur-

poses would be unimportant except in unusual cases.

Bender: We could go on indefinitely, but our discussion, unfortunately, will have to come to a close. In the few minutes left I would like to call on Professor Bardley to summarize for us the significance of what has taken place here this evening.

Bardley: That is a difficult thing to do in a few words. My contacts with you members of the profession have been exceedingly stimulating because I have always been able to find new postulates upon which the structure of both accounting practice and accounting theory is necessarily built. These postulates, many of them anyway, are always in the process of being remolded, and originate from the application of a keen insight to the secrets of business conduct. Accountants play a part in shaping the contents of the books of record of a business enterprise, but their chief duty is, and so far as I can see always will continue to be, to reflect for those interested the events in the life of a business for which others must necessarily assume the primary responsibility. The executives and employees of a business act; the accountant reports on their acts. He must be free to develop his own form of reporting, provided he is able clearly to envision the duties which society imposes on him in that respect. As long as his response is adequate he will need few regulations from the outside; but he must continuously be on the alert and seek to regulate himself and his fellows in accordance with his social obligations.

As Bender has intimated, the two of us seem to be pretty well satisfied that the regulation of the profession can best come through the selfimposition of standards or accepted rules. The effect will be threefold: first, the profession from such standards can more easily define its rules of ethics by the enforcement of which a profession exists; second, the public has a vehicle through which it can expect from the profession performances of a high order and can examine critically the foundations on which the profession rests; third, and most important, those practicing and otherwise vitally interested in accounting will have a basis upon which to grow. No comprehensive formulation of general accounting postulates has ever been made; those appearing in the book someone mentioned relate to a highly specialized field. The mere attempt to formulate, by a body of skilled practitioners, would in itself cause advancements, through the likely elimination of the many inconsistencies which we may now everywhere observe. It would focus our attention on fundamentals in terms of which we find it so difficult to think. Accounting could more successfully be taught. The benefits would be legion. We now expand our ideas from too many starts, some of them bad starts. We have too many conclusions; sometimes, I think, as many conclusions on a problem as we have accountants. Under such conditions it must be granted that our organization of principles has been permitted to shift for itself.

MacMurdie: We don't want to be restricted too much, but we don't wish on the other hand to have every accountant prepare essentially different financial statements for the same business at the same date. We could hardly defend our fellow practitioners before a court by contending that all our procedures are correct. We would immediately lose all the confidence which the public has placed in us.

Bardley: And so the case for standards marches on.

INCOME AND ITS MEASUREMENT

WILLIAM T. CRANDELL

SOME concept of income holds a prominent place in the consciousness of every individual. The very essence of economic activity is that of earning and enjoying income. As in the case, however, of many other terms of universal usage both in science and in business, the various concepts involved are confused and often conflicting. Even as a term used in technical economics, the definitions of income found in the writings of the leading authorities show pronounced differences of opinion. Professor Plehn introduced his subject, "The Concept of Income," before the American Economic Association in December, 1923 with the following words:[1]

> Economists have found income difficult to define. Professor Irving Fisher, in his book on *The Nature of Capital and Income*, published as late as 1906, characterizes economic opinion regarding the nature of income as "deplorably confusing and conflicting." Professor Seligman, writing in 1911, said: "The problem of defining income . . . is one that almost baffles the student." Still more recently, in 1921, the staff of the National Bureau of Economic Research said, with reference to income statistics, that "one of the most serious difficulties in working with these data is the difficulty of definition," and supported that statement by propounding a long series of unanswerable riddles concerning income.

Of the multitude of perplexing problems that arise in connection with defining income, Professor W. W. Hewett says:[2]

> Almost countless debatable questions press for answer. Is income the money one acquires within a period of time, or the goods one buys with the money, or the satisfactions experienced by the consumption of the goods? Should some commodities and services which do not involve money payments be included, as for example, the service of a dwelling house occupied by the owner himself? Are the savings one puts aside for future profit to be classed as income, or must only consumed earnings be counted? When a corporation adds to its surplus in lieu of dividends, has the shareholder received income? Gifts, inheritances, stock dividends, appreciations in property values —how shall they be classified?

Among the numerous definitions that are found in the writings of those who have attempted to deal with income in its various applications, the following are representative and seem to include most of the different conceptions held.

> Income is the money value of the net accretion to one's economic power between two points of time.[3]
>
> Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through the sale or conversion of capital assets.[4]
>
> Net individual income is the flow of commodities and services accruing to an individual through a period of time and available for disposition after deducting the necessary cost of acquisition.[5]
>
> Income (in the broad sense) [means] all wealth which flows in to the taxpayer other than as a mere return of capital.[6]
>
> A flow of services through a period of time is called income.[7]
>
> Income or profit of a given period may be defined as the increase in proprietorship which has taken place during that period, making due allowances for any part of such increment as may have been distributed.[8]

The above definitions may perhaps be said to comprise at least three, more or less distinct, conceptions of income, namely, (1) money income, (2) goods and services income, and (3) ultimate services (psychic) income. The difference between the concept of money income and income conceived as goods and services is not fundamental. In one case the attention is being focused upon

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[1] "Income as Recurrent, Consumable Receipts." *The American Economic Review*, XIV, 1 (Mar., 1924), pp. 7 ff.

[2] *Definition of Income and Its Application in Federal Taxation* (1925), p. 9.

[3] Haig, R. M., "The Concept of Income," *The Federal Income Tax*, (1921), p. 27.

[4] *Eisner* vs *Macomber*, 252 U. S. 189 (1920).

[5] Hewett, op. cit., pp. 22–3.

[6] U. S. Treasure Department, *Regulations* 77, sec. 21, Art. 41(a).

[7] Fisher, Irving, *The Nature of Capital and Income* (1906), p. 52.

[8] Hatfield, H. R., *Accounting—Its Principles and Problems* (1927), p. 241.

the means of measurement, in the other, the emphasis is laid upon the production of goods and services and their distribution among the factors responsible therefor. The concept of psychic income, however, is somewhat distinctive. From this standpoint, income is viewed in terms of the "final objective," the satisfactions enjoyed from the act of consuming goods and services, or perhaps one step removed from the satisfactions—the quantity of services received[9] from individuals directly or from the conversion of commodities.[10] The first type of income concept evidently recognizes a distinction between receipt of income and disposition or utilization of income. The second type of concept, on the other hand, denies the existence of income prior to the final use or consumption.[11]

"A good definition should conform to two tests; it should be useful for scientific analysis; and it should harmonize with popular and instinctive usage,—so far as this second condition is feasible and compatible with the first."[12] The ultimate-service conception of income is obviously faulty in that it is not in harmony with "popular and instinctive usage." For example, such commonplace expressions as "to live beyond one's income," "to consume one's capital," "to save a portion of one's income," and so on, are meaningless when used in relation to "service" or "psychic" income. One cannot but consume his psychic income, and whatever one consumes is by that very act turned into psychic income. Further, for purposes of statistical studies, the psychic income concept is altogether unusable. Satisfactions are entirely personal reactions and are different for each individual as well as on different occasions for the same individual; and no method of reducing these reactions to a common unit of measure is available. The "service" concept of income is as close to a measurable approximation of psychic income as it is possible to get. A money-value of the goods and services consumed is but a short step removed from the satisfactions enjoyed in their consumption. This is the essence of Fisher's "service" concept of income; but as pointed out above, it does not conform to the popular usage of the term.

All of the concepts of income discussed above connote an economic benefit to the recipient. It is then, mere tautology to employ the term "net income," that is, the benefit remaining after all explicit costs have been deducted. No benefit accrues in the mere recovery of necessary explicit costs.[13] This view must not be construed to include implicit costs, that is, expenditures of effort on the part of the recipient, for in that case income would simply mean consumer's surplus. There is a nice distinction at this point between production and consumption, between income and disposition of income, that is often difficult to mark. At just what point does the individual begin to consume his income? Do the extra rations and clothing that the manual laborer requires, that he would not require if idle, constitute necessary costs or are they a spending of his income for consumption? Undoubtedly, he *enjoys* a better appetite as a result of his labors, but he may not get any particular satisfaction from wearing his work clothes. A more important question, because of the relatively larger amounts involved, concerns the allocation of compensations for personal injuries, in industry. Do these compensations constitute costs or should they be regarded as distributions of income? They partake of the nature of both. From the viewpoint of the out-and-out fatalist, they are income;

[9] "Each atom of income consists in a service rendered by some kind of capital (including human beings). The amount of income in a period of time is the amount of such services rendered within that period." Fisher, Irving, "Comment on President Plehn's Address," *The American Economic Review*, XIV (Mar., 1924), p. 64.

[10] It should be observed that psychic income may be realized from the mere possession of a stock of wealth, from the experience of saving, or from the anticipation of consumption without any actual consumption whatsoever.

[11] "The test of income becomes the act of consumption, and unless consumption takes place no income may be said to be received. Income is not measured by money which *comes in*, but by money which *goes-out* for a specific purpose." Hewett, W. W., op. cit., pp. 28–9.

[12] Fisher, Irving, *The Income Concept in the Light of Experience*, a reprint of a pamphlet by him (1927), p. 2.

[13] "Income, therefore, always means net income." Seligman, E. R. A., *The Income Tax* (2nd ed. rev., 1914), p. 19.

construed as special hazards of industry, they are costs.

Situations in which Concepts of Income are Employed. "Income" is a term employed in economics, in taxation, in business and accounting, and in studies of national income. What does the term connote in each of these connections?

Economics, in general, is concerned with the income of the individual and the distribution of this income among the economic factors of production. The economic welfare and progress of the community are largely a matter of the efficient use of the resources available in satisfying the wants of the people. The amount of income available for consumption is probably more indicative of social welfare than the amount of goods and services that are produced. Viewing the Russian experiment as an example of allotting, for consumption, a bare minimum of the wealth produced, while the major portion of the productive capacity is directed towards accumulating capital goods, would the economist conclude that Russia has but little income, or would it be more appropriate for him to hold that Russia is saving most of her income? There is some reason for economists to think of income in terms of wants satisfied. Psychic income may be of real significance in matters of social welfare, and statistical measurements are not here so important. A money concept of income, or even a money-measure concept of income, would in many places fall short of approximating the economist's "real income."

Much of the income that contributes to economic sufficiency does not pass through exchange and hence can only indirectly come to be measured in money. Consumer's surpluses are real economic facts, yet, they are not capable, as a rule, of precise measurement in money. It must be concluded that "psychic" income is of real significance in economics and that concepts that are capable of actual measurement in money, are not the only concepts of importance in this field. Comparatively better living conditions and a more completely satisfied social group are acceptable means of measuring economic income. Money is merely the intermediate form of receipt, exchangeable for goods and services which are converted into the final form of income—satisfactions.

In the field of taxation and government finance, on the other hand, the center of interest is the productive power of the community—the national income. Taxation is largely a matter of diverting incomes from the direct consumption of individuals to the needs of government. Many government projects are simply those of producing immediately consumable services for individuals; but it is also a fundamental postulate of public finance that very long-term projects, such as reforestation, irrigation, and drainage, the benefits from which are slow in accruing, are best undertaken by government. The tax-paying power of a community is, then, that amount of income that can be diverted from immediate consumption rather than the amount immediately consumed. Money incomes are thus of the utmost importance in formulating tax policies. Public expenditures, on the other hand, should be largely concerned with ultimate satisfactions, that is psychic income. Accordingly while many taxes are levied on the basis of money incomes, public expenditures, in considerable measure, contemplate the distribution of services of government where psychic satisfactions will be increased, as in the case of parks, public protection, and so on.

The income of business enterprises is the primary concern of the accountant. This is perhaps the most commonly held concept outside the academic profession of economics. Just what is the nature of this practical concept of the business world? It is not, precisely, a money income concept; although it certainly does have some of those characteristics. The income must, for example, be a relatively immediate and definitely determinable claim to cash. The accountant's concept of income cannot be said to be, typically, a "goods and services" concept; although there are some characteristics that are common to both. There is very little in common, on the other hand, between the business conception of income and psychic income.

Students of national income enlist support from many fields of investigation. Sociological and other inquiries in the field of social welfare are usually concerned with national income in the psychic sense. The tax-paying power of the nation is largely a question of the money income of the country. The great majority of the citizenry of the country can best understand national income as the business man conceives income—as the national dividend and the net increase in national wealth combined. What, then, should be the conception of income in terms of which national income should be expressed? Studies of national income, in the past, have attempted to present conclusions in terms which involve more than one of these concepts.

> It follows, from the standpoint of individual income, that the correct way to attack the problem is to ascertain the changes that have occurred, during the period in question, in the wealth of individuals. This method treats income as composed of two parts: (1) *Current income*, and (2) *Gains or losses in the value of property owned.*
>
> Current income, though a somewhat hazy concept, . . . is estimated here by summating (1) wages, salaries and pensions, (2) profits withdrawn from business, (3) dividends, interest, and rent received by individuals, (4) the rental value of homes occupied by their owners, (5) interest upon the sums invested in household furnishings, clothing, and the like, and (6) the value of commodities which families produce for their own consumption . . . there are good reasons for approximating as closely as possible gains and losses in the value of property owned, and for giving these approximations a place in the income account.[14]

The above quotation indicates the extent to which one of the publications of the National Bureau of Economic Research digressed from the money and business concepts of income to include imputed incomes from owned property. The inclusion of income resulting from increased value of property owned is in sharp contrast to the psychic or service concepts of goods and services consumed.

> . . . Its staff was directed to undertake a thorough canvass of all the available materials and to make as close an estimate as possible of the size of the National Income, its variations from year to year in dollars and in goods, and the way in which this income is divided among the people.[15]

A considerable concession to the psychic concept of income is implied in the initial directions, quoted above, given by the Board of Directors of the National Bureau of Economic Research to their staff in outlining the first inquiry attempted by this Bureau. Not only were the staff to make their estimates in current dollars, but some attempt was to be made to estimate real income. Practically all studies in this field employ some means of "deflating" dollar incomes to incomes of constant purchasing power—an acknowledgment of the fact that current dollar estimates leave something to be desired as an expression of national income.

It is not unreasonable, then, that there should be a number of distinct conceptions of income, each having the characteristics that make it especially useful in its particular field of investigation. In those fields involving deductive analysis, where general social welfare is the dominant consideration, money measurements of income are liable to fall short of supplying the data necessary for comprehensive conclusions. For example, sociology is concerned almost exclusively with psychic income. It might very well be challenged whether a larger income of goods and services, as measured in money, always makes for more psychic income. Psychic satisfactions are liable to be relative measures. Aggregate magnitudes extending over long periods of time often lose significance for such measurements. A like money income in 1933 might very well render substantially different satisfactions from the same money income in 1800, or even a like purchasing-power income.

In other fields, however, aggregates are of primary importance. The amount of taxes to be levied, for example, is a fairly definite aggregate amount. Its calculation involves

[14] Leven, M., *Income in the Various States* (1925), p. 28.

[15] The Staff of the National Bureau of Economic Research, *Income in the United States* (1921), Vol. I, prefatory note, p. ix.

definitely measurable magnitudes—it must take into account the amount of money that the taxpayer can actually lay his hands on. The business man is concerned with an account of the success of his undertaking in definitely measurable amounts. It is of prime importance for him to know the aggregate amount he has invested in the enterprise, a current reporting of the extent to which he is recovering his investment, and the amount he is realizing in excess—his net income. Money measurements are indispensable in these fields of inquiry.

There are several reasons why it seems desirable to employ the accountant's concept in estimating the national income, at least in the initial stages of this study. First, the concept is perhaps more commonly used and hence better understood than any other income concept. Second, it provides a valuable means of checking the accuracy of estimates and of avoiding the fallacy of "double accounting" by correlating the national income and the national wealth. Third, practically the only data available for a statistical study of national income must come from financial records that are the product of accounting.

Since the accountant's concept of income is to be taken as the basic concept in this study, a more careful examination of its characteristics and the underlying techniques involved may well be made at this point.

The Accountant's Concept of Income. The accountant is concerned with measuring current income accruing to the investors of capital funds as it arises in business undertakings. Reporting the situs of the equity in this new wealth among the individuals and interests contributing to its creation is one of his major tasks. The final disposition of the income distributed to the parties whose goods and services were utilized in the production, is of comparatively little concern to him. He is, however, interested in that part of the income that is reinvested in the particular business enterprise. His task is to account for the cost of all the property entrusted to the venture and for the equities of the several parties contributing it. From his point of view, the remuneration for the goods and services furnished by others than the owners and investors of permanent capital in the enterprise, are not a part of the "net income" of the enterprise, but must be deducted from gross returns before net income of the business is determined.

As a practical tool of the business world, relied on largely as a means of measuring the success of business ventures and as a guide to management in business operation, the accountant's technique is influenced greatly by practical considerations and his theories of value accretion are often tinctured with business expediency. A case in point is the presistent adherence to the view that the sale transaction is the sole criterion of income realization. As J. B. Canning[16] points out, however, "it can be said with assurance that recent practice is tending towards finding the critical stage [recognizing the accrual of income] earlier and earlier in the cycle of operations." Regarding the several stages at which income may be recognized, he says:[17]

> There are many stages in the cycle of operations that have been made to serve as the critical stage at which income emerges. In many enterprises that stage is cash receipts; in most great enterprises it is the stage at which the sale occurs [or at which the service has been rendered for which a future ascertained payment separately becomes due]; in some instances it is the completion of the goods which are contracted to be sold even though delivery has not been made or tendered; in a few instances the completion of the goods ready for sale even though no sale is made or contracted to be made, is the critical point.

Although, as was pointed out above, income is always net by definition, there is nevertheless, considerable advantage to be gained from focussing the attention, at certain points, on the total returns from business operations, of which income is the residual part. One finds the terms "gross income," "gross receipts," "gross earnings," "gross revenues," and "gross returns" applied to this aggregate. Any title which employs the term "income" is logically a misnomer since the aggregate is not a net amount. "Gross receipts" implies money

[16] *The Economics of Accountancy* (1929), p. 103.
[17] Op. cit., p. 104.

receipts (cash sales or collections following credit sales) and the term relates particularly to the concept of money income. The last three terms may be used synonymously without much danger of misinterpretation.

Gross Earnings, Expenses, Net Income. Income conceived in terms of goods and services, measured in money, is the resultant of two phases of the work of the accountant. The first consists in accounting for the total returns for the goods and services sold, often referred to as "*gross revenue*," the second phase involves the allocation of this total return among the parties or factors responsible for the production of the goods and services. This second phase is normally deemed to comprise at least two distinct operations. The first of these is the allocation of that part of the total returns which represents the contributions of goods and services purchased from parties not part-owners or investors of permanent capital. The amounts thus allocated are termed *expenses*. The second involves assigning the remainder of the gross earnings, the "*net income*," among the several part-owners and investors in the undertaking. The net income may be allotted as contractual payments, such as interest; voluntary disbursements to proprietors or stockholders; or as additions to proprietary accounts of that part of net income which is reinvested, either temporarily or permanently, in the business.

Normally gross earnings measures the amount realized in current dollars, or in relatively immediate claims to current dollars, from the sale of the product or services of the enterprise. As was pointed out in the quotation above, however, other stages in the cycle of operations are sometimes accepted as criteria of income realization.

Incorporated in the cost of the product or services produced by the business enterprise, are the costs of the services of the enterprise assets consumed or converted as well as the cost of the services directly purchased and converted in the productive process. These asset costs become *expenses* as they attach to the product or service sold. It is well nigh impossible to assign to any small lot of the product sold, the exact amount of costs that are embodied in and attached to it. This difficulty of assigning expenses to their particular earnings is perhaps the most difficult problem the accountant faces. Upon a correct solution of this problem, of course, depends the correct periodic reporting of net income and its distribution among the equities to which it accrues.

Receipts and Accruals. The accountant's conception of gross earnings closely resembles the concept implied in the term "gross receipts," that is the total money received in exchange for the goods and services sold. Imminent fruition in money is a prime requisite to practically all criteria of periodic income realization, even on the "accrual basis." The "accrual basis" of accounting for *expenses*, on the other hand, is materially different from the "cash basis," and consequently the accountant's periodic *net income* is quite different from net income realized in money. The principal difference between the accountant's concept of income and the money concept lies in the amount of depreciation estimated by the accountant as an expense. Most of the goods and services acquired by business enterprises, such as the services of employees, of insurance companies, the materials and supplies, and so on, are consumed or converted in the productive process, within a comparatively short period of time after purchased. Interpreting them as expenses as they are paid for would not be an egregious error. Some property used in production, however, releases its services over a relatively long period of time; such property is purchased and paid for in large amounts and at considerable intervals of time. The leading examples are plant and equipment. A cash basis of recognizing expense for these items would be materially different from the accrual method employed by the accountant. The accountant assumes that services are rendered by depreciable property more or less continuously over its useful life, and that as the services are rendered the asset value of the property is dissipated. This is the essence of the concept of depreciation.

For those goods and services that are consumed as acquired, the returns from gross revenue are required at once to replace them. For the services of depreciable property,

gross revenue provides resources (in the case of successful conclusion) that are in excess of immediate requirements for replacements. A money concept of income would count this excess as income, while the accountant's concept of accrued income would regard this excess as a return of capital for property long since paid for, and not as net income. The same distinction is implicit in receipts of interest on securities bought at a premium, or in receipts from a terminable annuity—part of each receipt is a return of principal, not all of it is income.

In other words, the accrual method of accounting for income is based on the assumption that the capital is left intact and that net income is the amount realized over and above that necessary to preserve the principal. To be sure, the income may be spent for consumption goods and services, or it may be spent for other production goods; the income is determined independently of whether it is saved or consumed.[18]

The Accountant's and Economist's Concepts Contrasted. It is altogether reasonable that the accountant's concept of income should contrast sharply, in many respects, with the economist's. In the first place, as was pointed out above, the accountant is primarily concerned with the income of particular business enterprises, viewed especially from the standpoint of the investors of permanent capital. The economist, in contrast, is concerned with the ultimate distribution of the new wealth produced. Second, the economist thinks of income as the "net product" available for distribution among the several functional factors of production whose distributive shares are rent, wages, interest, and profits. These factors are conceived of as, respectively, land, labor, capital, and responsibility-taking, and are personified as landlord, laborer, capitalist, and entrepreneur. The accountant's net income is the amount accruing to the investors, the distributive shares being interest, dividends, and surplus. The beneficiaries of the accountant's net income are separate entities; natural persons or their legal representatives, associations of various kinds, and other enterprises. These distributive shares are not the price-determining shares as conceived by the economist, they may include a producer's surplus. The marginal supplier of the economist's factors of production is in fact hard to identify in actual business, and the different economic factors, as the economist conceives them, are seldom found isolated in separate natural persons.

Further, although the terms "rent," "wages," "interest," and "profits" are commonly found in accounting nomenclature, they are not comparable to the corresponding functional shares to which these terms refer in economics. Some of the terms that refer to distributive shares in economics refer to expenses in accounting parlance, as for example, "wages" and "rent." Each term, as used in accounting, is generally a composite of two or more of the terms as used in economics. Thus, although wages are seldom separately reported in accounting, the wage payments invariably include elements of one or more of the other shares as conceived in economics.[19]

The economist apportions the gross returns among the several functional economic factors of production. The accountant in his books, apportions the gross returns of business according to the internal classification adopted by the particular enterprise as most useful for managerial purposes, as for example, by departments, operations, kind of goods or service used, class of business transaction, type of security evidencing the investment, and so on. The payments or actual distributions are made to either natural persons or other business enterprises. No attempt is made by the accountant to classify the apportionment among the functional economic factors of production.

In economics, in the price-making process,

[18] Cf. Fisher, I., *The Nature of Capital and Income* (1906), p. 134.

[19] "Profits, as the term is frequently used by the general public, include the whole net return to the responsible owner of a business after money outlay has been deducted from money receipts. This whole return usually includes at least three elements, (1) wages of some sort, principally for management, (2) interest on capital invested, and (3) a remuneration for taking the responsibility of production and making certain final decisions which necessarily fall to the owner." Taylor, F. M., *Principles of Economics*, ninth edition, p. 494.

each of the distributive shares is assumed to accrue concurrently as production progresses and the total economic cost is precisely equal in the critical price-determining instance, to the amount paid by the buyer. The accountant, on the other hand, assumes that net income suddenly emerges as the final act in a series of events—usually when the sale is consummated—and that net income, especially that accruing to the proprietors, is residual.

Finally the economist recognizes income only when it reaches the ultimate consumer, a natural person. The accountant, in contrast, reports income at the various stages of production, as the product passes from enterprise to enterprise, on its way to the ultimate consumer.

The above distinctions between the accountant's concepts and those of the economist are summarized in the following:[20]

> While it is true that from the standpoint of economics there is much force in the assumption that business income accrues as surely as do the actual costs incurred by the buyer, there are fundamental objections to the general adoption of such a conception by the accountant. Accounting, it must be remembered, deals with specific enterprises; and hence the accountant must adopt essentially the viewpoint of the owners and managers of the particular business entity. And from the standpoint of the owners, costs incurred—purchased commodities and services—constitute a very different classification as compared with the peculiar services and conditions implicitly furnished by the business itself. The business does not buy or incur its own services; hence their value should not be entered as if they had been actually acquired. It is the buyer of the completed article who purchases the services of the producing enterprise. The expense of doing business and the net return are quite distinct from the standpoint of the owners. Expenses are actually incurred; there is no assurance that income is thereby accruing. One process is a definite matter of record; the accrual of income would be based purely on assumption. The whole scheme of modern income accounting is organized in such a way as to show net return as a residuum, a difference between selling value and expenses. To accrue profit in general on the basis of completion percentages would be entirely unsound. Only where sale is assured, and the process long, should any such accounting be attempted.

Failure to recognize the contrast between the economist's point of view and that of the accountant has led to some accounting practices that tend to defeat the purpose for which accounts are kept. Inclusion, in explicit expenses, of economic costs such as salaries of the proprietors, rent of owned property and interest on the proprietary investment are examples. To argue that these items should be included in the accountant's expense category is to argue that accounting for the individual enterprise should be abandoned in favor of accounting for total economic costs from the standpoint of the entire market situation. To make the costs of separate businesses conform to and reflect economic costs is, as a practical matter, well nigh impossible. If it were possible definitely to determine economic costs, and if the individual enterprise were to make its costs coincide therewith, the net profit balance would indicate only the intramarginal producer's surplus, if any, or the amount by which the company failed to realize economic profit or other return. No comparative data would result, the costs of all the enterprises in the same industry would be alike—marginal costs.

The whole question of whether actual historical costs or imputed costs (this includes all costs that are not actual, from the point of view of explicit transactions entered into between the particular enterprise and other parties) should consitute accounting data is that of whether the accountant can or should attempt to account for enterprise income on the basis of the same set of concepts that the economist uses. The inclusion of imputed costs of any variety, in the accounts, invariably results in a confusion of expenses with aspects of business income or its distribution.

NOTE: An individual might conceivably view income as the annual amount available to him for purposes of consumption, due provision being made for the continuance of the income throughout his life. To illustrate:

(1) For a person, all of whose income is from

[20] Paton, W. A., *Accounting Theory* (1922), pp. 461–2.

property, the amount available for consumption each year would be an annuity which would terminate with his death. For example, suppose an individual owned bonds costing $200,000.00 par and yielding an effective and bond rate of interest of five per cent. This is his sole source of income. What should he consider as the net income that he can use for living expenditures, pleasures, and the things that we commonly think of income as being spent for? Assuming that his life expectancy is fifty years from date, he could purchase, for $200,000.00, a fifty-year annuity of $10,955.35. The annual interest receipts from the bonds are $10,000.00. He might providently consider his income as $10,955.35, selling a portion of his holdings to supplement his interest receipts. This concept is not one based on what he consumes, but it is based on what he can providently consume. It includes a part of what one would normally call "principal." It is not a part of his principal in the sense that he is undermining his future income.

(2) For an individual whose only source of income is his own services, net income for the year might well be construed as the returns from his personal services less an amount which he should invest in property to provide for his unproductive years. Suppose, for example, that an individual, owning no property, is able to earn from his personal services, $10,000.00 per year. Assume that this earning capacity will endure for twenty years, after which time he will no longer be able to earn anything from his own services. Suppose, further, that his expected life is fifty years from date, that is, thirty years beyond his earning life. What should he consider as his net income available for consumption, having in mind provision for the continuance of this income for life?

The amount of $3,173.60 per year, invested at five per cent compound interest for twenty years, will yield a principal sum of $104,938.49. This yearly investment from his earnings will leave $6,826.40 as his consumable income. $104,938.49 will purchase a thirty-year annuity, at five per cent, yielding $6,826.40. The net amount that he could spend every year of the remainder of his life, from the above assumptions, would, then, be $6,826.40. It is, of course, quite senseless to maintain that this individual should save a capital fund out of his personal service earnings to provide an income in perpetuity. That sort of an income concept is of no value to him because he cannot use an income that long. An income beyond his natural life would not be an income to him but to someone else.

This concept is not unlike that generally held in relation to income from natural resources. The corpus of the resource is assumed to have been acquired by the original owner free of cost. The only costs that he incurs are assumed to be those incurred in the discovery and those required to extract the resource. All returns in excess of these costs are income. Thus, in reality, a part of what is generally regarded as income in this field, is return of principal. The Internal Revenue Department, however, virtually allows the discoverer, under certain specified conditions, to set up a discovery value in the case of mines and oil wells, and to deduct (not to exceed fifty per cent of the net income of the discoverer, computed without allowance for depletion) depletion thereon for income tax purposes.

Gifts and inheritances are commonly treated in the same manner. That is, all returns from an inherited estate are considered income, even though the estate may not be preserved.

The Accountant's Concept, his Assumptions and Technique. The accountant is more or less aware of many of the different concepts of income that are common to the several fields of social work and economics. His peculiar task, however, is that of interpreting a great variety of business transactions in terms of concepts that will be helpful in the conduct of business and make available, at frequent intervals, data that will be historically accurate and at the same time pertinent to management. Some of his more serious problems, as suggested by the following, are treated below.

Ultimate Total Income and Periodic Income
Appreciation, Capital Gains and Losses
Expenses, Losses, and Assets
Depreciation
Changes in the Value of Money
Avoidance of Double Counting
The Technique of Consolidation

Ultimate Total Income and Periodic Income. The difficulty of imputing expenses to individual sales or even to the gross earnings of the accounting period, the month or year, is an ever present problem for the accountant in the periodic determination of enterprise income. The longer the period for which the income is to be determined, the smaller the relative amount of error. Absolute accuracy can be attained only when the venture is completed and the enterprise

terminated. The total expenses incurred throughout the undertaking can then be said to apply to the gross returns for the same period.[21] Income calculation for a period less than the duration of the venture, involves consideration of the different criteria of income realization, that is the period in which the income is to be recognized, and, in addition, the allocation of the expenses to the revenues as recognized. Many of the services utilized in the business of producing or assembling and selling a product do not attach to particular units in a manner direct enough to permit more than an approximation of accuracy. Some services are utilized as a function of time—insurance, for example; other services are utilized some time after the product itself is sold and delivered. Thus, for example, agreements to "service" and keep in running order, for a specified time, a product like a piece of equipment, may call for services after the equipment is sold and delivered. Many services are so general as to almost defy logical allocation except the obvious one, that they belong to all of the earnings for the entire venture. Cost of organizing the enterprise are of this nature; developmental costs and depreciation are also of this nature. Obviously, it is impossible to apportion such costs accurately over less than the entire revenue of the undertaking, and it follows that it is also impossible to calculate net income accurately for a period less than the duration of the enterprise.

For effective administration of business, nevertheless, it is important that the accountant furnish some data indicative of the success of the venture before the enterprise is terminated. It is, in fact, imperative that rather close approximations to the trend be disclosed at frequent intervals.

Appreciation, Capital Gains and Losses. A part of the ultimate net income of an enterprise can be assigned in some cases to natural growth and other increases in value. In the case of timber tracts, orchards, and similar properties, natural increase, commonly called *accretion*, is an important factor in financial history. In other cases enhancement of property values due to changing business and general economic conditions, a general rise in the price level, or other factors which result in an increase in effective value over actual cost, usually referred to as *appreciation*, are of marked significance. At what point, in the succession of events that lead to final fruition of these gains in cash, should the accountant recognize the change? Eventually, if no cognizance is taken of it before, the gain will be realized in cash when the property itself, or the product resulting from its use, is sold. Until such time as the gain is validated by sale, the increased value is commonly characterized as unrealized and the gain as "unearned" or "unrealized income." The following definitions of "realized income" and "unrealized income" are found, at least "by implication if not in the form of outright statement:

1. Unrealized income is income not yet realized in cash.
2. Income is not fully realized until it is actually available for dividends.
3. Unrealized income [paper profits] is apparent income remaining tied up in the same type of commitment as gave rise to such income."[22]

One of the most controversial aspects of income determination is the relation of "unrealized income" to revenue. It is generally agreed among accountants that pure accretion constitutes a form of income in the "unrealized" stage. The major difference in opinion centers around the recognition of unrealized income from appreciation. H. W. Sweeney holds that "All the income—realized, unrealized, and the total thereof—coming into existence during a period should be credited to that period, but the realized should continue to be separated from the unrealized."[23] This is the generally accepted

[21] This viewpoint suggests another concept of income that is in contrast with Fisher's notion that income is a "flow of services through a period of time . . . ." Income may reasonably be thought of, not as a function of time at all, but in terms of an undertaking. Thus, the performing of a particular job results in income, but no income at all is earned until the job is completed.

[22] Paton, W. A., *Accountants' Handbook* (2nd ed., 1932), Sec. 20, p. 1097.

[23] Sweeney, H. W., "Income," *The Accounting Review* (Dec., 1933), p. 335.

version whenever appreciation is taken up on the books. The unrealized appreciation is recorded in a special surplus account and transferred to earned surplus directly or included in income as the appreciation is realized through sale or other disposition. Because of the difficulty of following constantly changing market prices it is generally deemed inexpedient to separate income due to appreciation from the other types of income ultimately realized through sale. This is especially true of the great variety of items constituting the "stock in trade" of the general merchant. If current costs should be recognized in the income accounts, the balance sheet should by the same token reflect current values. The assumptions underlying such a scheme of accounting are that the materials sold are purchased at the moment of sale and that the final inventory is purchased as of the inventory date. Any gains or losses resulting from actual purchases at other times are construed as gains or losses from price changes. The following example illustrates the difficulties involved in accounting for income accounting in this manner.

Assumptions: (1) 1000 units of material are purchased at $1.00. (2) 400 units are sold for $1,200.00 when the market price is $1.50; 500 units are sold for $1,300.00, the current market price at the time of sale being $1.80. (3) 100 units, with a current market price of $.90, are on hand at the end of the accounting year. There are no costs other than that for materials, and all transactions are for cash.
Accounting Treatment:

(1)		
Materials (cost)	$1,000.00	
Cash		$1,000.00
(2)		
Cash	2,500.00	
Sales		2,500.00
Materials (appreciation)	680.00	
Realized appreciation		600.00
Unrealized appreciation		80.00
600 units appreciated from $1.00 to $1.80 and 400 units appreciated from $1.00 to $1.50.		
Appreciation from $1.00 to $1.50 realized on 400 units and from $1.00 to $1.80 on 500 units sold.		
Unrealized appreciation on 100 units from $1.00 to $1.80 that were unsold.		
(3)		
Unrealized appreciation	80.00	
Realized loss	10.00	
Materials (appreciation)		90.00
All unrealized appreciation from $1.00 to $1.80 on 100 unsold units is lost.		
A net loss of $.10 each realized on 100 unsold units when market cost fell below historical cost (from $1.00 to $.90).		
Decline in value from $1.80 to $.90 realized on 100 units.		
(closing entries)		
Sales	2,500.00	
Current income		2,500.00
Current income	1,500.00	
Materials (cost)		900.00
Materials (appreciation)		600.00
To close to Current (Operating) income the current market cost of the materials sold.		
Current income	1,000.00	
Net income		1,000.00
To close into Net income the current income from operations.		
Realized appreciation	600.00	
Realized loss		10.00

Net income	590.00

To close into Net income the net amount realized from appreciation and loss in value of materials, thus recognizing appreciation as a phase of Net income.

Income Sheet

Sales					$2,500.00
Less:					
Cost of Materials sold: (market)					
Purchases (cost)			$1,000.00		
Appreciation	$600.00				
Less: loss	10.00		590.00	$1,590.00	
Less: Inventory: at cost		$100.00			
Less: decline in market		10.00		90.00	
Market cost of materials sold					1,500.00
Operating income					$1,000.00
Appreciation income:					
Realized appreciation			$600.00		
Less: realized loss			10.00		590.00
Total Net income					$1,590.00

Balance Sheet

Assets		*Equities*	
Cash	1,500.00	Net Income	$1,590.00
Inventory (at market cost)	90.00		
	$1,590.00		$1,590.00

By "unrealized loss" is generally meant a decline in value of unsold property due to changes in prices or other factors beyond the control of the management. As in the case of unrealized gain, many hold the opinion that such losses should not be booked until realized through sale. The Bureau of Internal Revenue, for example, does not permit holders of securities (other than dealers in securities) to deduct such losses in the value of their holdings, for purposes of the income tax, except where utter worthlessness can be clearly demonstrated. This would be an unfortunate attitude for the accountant to take, particularly in regard to readily marketable securities. The loss is unquestionable and the amount definitely measureable. With respect to land and other property values, market prices are more tinctured with estimate; the actual loss and the exact measure of it are not quite so apparent.

Unless the change in value is of an appreciable amount, definitely measureable, and of a relatively permanent nature, neither unrealized gains nor unrealized losses should, in general, be recognized by the accountant. In any case the actual cost data should be preserved in the accounts and the recognized variations therefrom segregated in special valuation accounts. Capital gains and losses are generally regarded as special adjustments to surplus when realized, seldom are they combined with current income in accounting practice.

Expenses, Losses, and Assets. Closely related to the task of assigning costs to periodic revenues, is the problem of differentiating between expenses, losses, and charges to property. Although the theoretical distinctions are clear, it is not always obvious, in practice, whether a particular charge constitutes a cost of current revenue, an outright loss without any compensation, or

whether the charge is assignable to future revenues and hence should be construed as an asset. The concept underlying a large part of the asset classification in the typical balance sheet is that of costs chargeable to future revenues. Such charges are ordinarily referred to as "capital charges" or "deferred charges." The criteria for capital charges include the following:

1. Expenditures for services that are rendered as a function of time and covering several accounting periods, such as insurance premiums.
2. Expenditures that are made in connection with transactions, the revenue from which will not be recognized until some future period, as for example, costs of developing or selling a product the revenue of which is to be recognized by the "installment method."
3. Improvements to depreciable property, or replacements at a cost higher than the original cost of the unit being replaced.
4. Expenditures that will increase future revenues.

Occasionally charges are made to current expenses in anticipation of future losses or expenditures. To the extent that the future losses or expenditures are highly contingent and problematic, the current charge has little validity. As an extreme view, all of the assets might be charged to expense in anticipation of possible future reverses. Where the future expenditures are definitely foreseeable and measurable, the current expense charge may be legitimate. Examples of such charges are found in connection with leaseholds, where the lessee is obliged by contract to restore the property, at the termination of the lease, to its original condition as taken over. The cost of dismantling depreciable property is often prorated over the useful life of the property by charges to expense.

Depreciation. A part of the problem of periodic accounting for income is that of depreciation. As already pointed out in this study, periodic income accounting is no more or less than an attempt to account, piecemeal, for the ultimate total net income of an undertaking. The sum of the several periodic net incomes should, then, be the ultimate net income of the venture. There are seemingly little grounds for maintaining that anything but actual cost should be considered as expense for the entire venture. The probability that the costs will be higher for a similar subsequent undertaking really has no bearing on the costs of the present one, and should not be allowed to affect the determination of present costs. To use any basis other than cost is, in effect, to impute to the current period, costs that would have been actual if conditions had been different. There is very little support for the proposition, for example, that labor costs of the current period should be ignored and the costs that will probably have to be paid ten years hence substituted therefor. Depreciation based on the probable cost of future replacement prices has no better claim to validity.

There is, perhaps, more logical support to account for income on the present replacement cost basis. This basis is an attempt to show effective costs, but it is impossible, at the same time, to show the current market cost of depreciable assets on the balance sheet. That is, it is impossible to assume that the unit in use was purchased at the time it was used—perhaps at the average market cost during the period—and at the same time assume it was purchased as of the inventory date. There is a difference between the average price during the depreciation period and the price at the end that must be assigned to either the depreciation of the period or the asset at the end of the period. The current replacement cost basis for estimating depreciation cannot claim to maintain physical capital as does the future cost of replacement basis, for only the last charge for depreciation is based on the cost necessary to replace the unit.

There is still some feeling among business men and even among accountants, that depreciation is quite a different sort of expense from the other expenses that are purchased as they are converted. It is often felt that the amount of depreciation is more or less arbitrary, that it is no great offence to manipulate the amount to effect a more favorable showing in the income sheet. Other expenses are sometimes characterized as out-of-

pocket costs in contrast to depreciation. Depreciation is just as much an out-of-pocket cost as any of the expenses, in fact it is likely to have been the first out-of-pocket expense. The expense is not paid during the current period, to be sure, but that is because it has long since been paid. Income sheets are often drawn up in a form to imply that depreciation is the last of the expenses to be recovered. There is no preferential order in which expenses are recovered. The net income is conceived as the last element in gross revenue to be recovered, but it is questionable if this view can be substantiated in logic. There is no such thing as "net income before depreciation," until depreciation is accounted for, net income cannot be disclosed.

Changes in the Value of Money. Accounting for the national income in terms of social income connotes taking into account changes in the purchasing power of money. King of the National Bureau of Economic Research[24] expresses his attitude on the matter as follows:

> The most convenient unit for measuring the income of the people of the United States is the dollar. But, as it happens, the dollar of 1909 was a very different unit from the dollar of 1919, and the latter in turn had little resemblance, in its purchasing power, to the dollar of 1921. Although, throughout the period, the United States Government has always been ready to redeem its money in gold dollars of constant weight, these gold dollars have varied greatly in their ability to purchase goods. If, therefore, we were to express the income of the people of the nation in terms of the dollars of the various years and make no further corrections, the changes in the totals would have little significance, and we might be accused of attempting to deceive the public as to the facts. What counts with the average citizen is not how many dollars he receives per annum, but how many goods a given number of dollars will buy.

The accounting fraternity does not consciously aim to reflect in their accounts changes in the value of money; the accountant aims rather to report income in the dollars current at the time. Unconsciously, perhaps, some allowance for these changes are often advocated. For example, in attempts to include imputed costs, as outlined above, in the expenses, the urge to express, in the accounts the changing value of money may often be the motive. Charging depreciation at replacement cost is purely an attempt to book present or future prices instead of the prices paid some time in the past.

In accounting for the national income, however, the purpose may be to measure the relative welfare of the people of the nation and their progress towards better living conditions. Money, as such, does not assume the importance in national income accounting that it does in enterprise accounting where the outlays are for the most part made in current dollars. Money to the nation is comparable to tokens or departmental debit and credit memos within an industrial enterprise, simply a medium of internal exchange. Thus, in measuring national income, changes in the value of money might well be eliminated, in so far as this is possible. The selection of the index of these changes is, then, of primary importance.

Regardless of what doctrine is held with respect to the relation between gold and money, and between money and the price level, there is no denial that the value of money changes from time to time. If an index of prices made up of all commodities and services produced during the period were applied to the income accounted for by the electric light and power industry, the result would show the purchasing power of that income in terms of all commodities that are purchased in that period. An index of prices of commodities and services that go to make up the budgets of families as consumers, would, if applied to the national income accounted for by any industry, show the relative purchasing power of this income in terms of standards of living.

Probably the best single index to be applied for purposes of estimating the purchasing power of any part of the national income, is that index of the prices of goods that go to make up the "cost of living" index reported by the United States Bureau of

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[24] *The National Income and its Purchasing Power* (1930), p. 65.

Labor Statistics.[25] The index is available to all and its merits are fairly well known. In support of an index of the prices of consumers' goods, to be used in national income studies, King of The National Bureau of Economic Research[26] says:

> For several reasons it seems wisest to use, in the construction of an index number, the values of consumers' goods only. First, all other classes of goods are purchased not with a view to the service which they themselves will render, but in the expectation that they will add to the possibilities of economic gain. The services anticipated from all classes of production goods, securities, etc. are then indirect, while the services rendered by consumers' goods are direct. This means that the market values of all indirect goods depend upon the guesses as to the probable values in the future of the direct or consumers' goods into which the indirect goods are expected to mature.

J. M. Keynes[27] supports a cost of living index as the real measure of the purchasing power of money, in the following quotation:

> Is there any one of these Price-levels, and if so, which, corresponding *par excellence* to what we mean by the Purchasing Power of Money? We need not hesitate over the answer to this question. However great the theoretical and practical difficulties of measuring *changes* in the Purchasing Power of Money, there need not be any doubt as to what we mean by it. We mean by the Purchasing Power of Money the power of money to buy the goods and services on the purchase of which for purposes of consumption a given community of individuals expend their money income.

Avoidance of Double Counting. Up to this point the accountant's technique and his assumptions have been surveyed with the purpose in mind of appraising their applicability to the problem of determining national income and national wealth. The following discussion purports to show how the basic technique of double-entry accounting avoids one of the most serious fallacies often committed by economists and others—that of double or multiple counting of income. Alfred Marshall[28] cautions against this fallacy in the following much-quoted passage:

> We must be careful not to count the same thing twice. If we have counted a carpet at its full value, we have already counted the values of the yarn and the labor that were used in making it; and these must not be counted again. But if the carpet is cleaned by domestic servants or at a steam scouring works, the value of the labor spent in cleaning it must be counted separately; for otherwise the results of this labor would be altogether omitted from the inventory of those newly-produced commodities and conveniences which constitute the real income of the country.

Professor Fisher[29] states that to count the new wealth created and to count the income that this new wealth subsequently gives rise to, is a species of double counting. This view is the result of confusing revenue or total return and income. Unless the wealth gives rise to other wealth (revenue) in excess of the amount consumed or converted, of course there is no income. Capital goods give rise to income in the sense that they make possible the combination of their own services with the services of the income recipient, which latter services constitute the income. Unless the combined services of the capital good and the income recipient will return more than enough to replace the capital good, then the income recipient receives nothing for his services and no income results. If on the other hand, one were to count as income, the entire return from the services of both the capital good and the income recipient, there would most certainly be double counting, because the benefits or returns from the capital good were all counted as income when the capital good was created.

Suppose for example that a man were to invest $10,000.00 in a building which he lets out for hire, at $100.00 per month. What is his income? When was the $10,000.00 income? The $10,000.00 must have been income some time before he invested it in the building. The investment in the building

[25] Cf. The Federal Trade Commission, *National Wealth and Income* (1926), p. 225.

[26] Op. cit., p. 66.

[27] *A Treatise on Money* (1930), p. 54, and Cf. Marshall, A., *Money Credit and Commerce* (1923), p. 30; "The general purchasing power of money should properly be measured by reference to the retail prices paid by the ultimate consumers of finished commodities."

[28] *Principles of Economics* (1920), p. 79.

[29] Fisher, I., *The Nature of Capital and Income* (1906), p. 108.

gives rise to no income, no new wealth is by this act created. The rentals of $100.00 per month may or may not give rise to income. If $100.00 per month is enough to permit the recovery of the $10,000.00 invested in the building, all other costs necessary to keep the building rented, and some return to the owner for his efforts, then there is income to the extent of the returns to the owner. If a man were to earn $1,000.00 and invest it in an automobile, when would income result? The $1,000.00 was income before it was invested, it should be counted as income when it was first earned. From that time on (assuming that the automobile is used only for pleasure) income is being consumed. During the life of the machine the owner will consume income to the extent of $1,000.00—and more, to the extent of the gasoline, oil, and repair man's services that are required to run the car. The owner must earn more income from other sources to pay for the repairs and the garageman will earn income when he repairs the machine. There is nothing peculiar about the fact that $25.00 is earned by the owner when he furnishes legal advice, for example, and that $25.00 is earned again by the garageman when he repairs the car. The same $25.00 in money tokens may be involved in both cases but two different services were rendered and each service should give rise to income. The same $25.00 in tokens may, as a matter of fact, be the evidence of a good many incomes earned before it is destroyed by the issuing bank. Every time it evidences the creation of new wealth or services, it will be earned.

To deny that capital produces a return to the owner is to deny that capital is productive. This does not simply imply that capital is reproductive, but that capital will give rise to income—something beyond enough to preserve the principal. The only incentive to postponing the use of current income is the prospect that it will bear income in the future. Fisher, continues at this point to insist that savings cannot be counted as income. Of course, it is all the same argument, savings are effected by investing in capital goods, the income is determined independently of what becomes of the income.

Although he regards accounting as a "complete, consistent, and logical system,"[30] Fisher does not seem to understand its technique thoroughly. "It is true that the value of the new house must be entered on the capital balance sheet, but the cost of producing it belongs properly to income accounts."[31] The above quotation certainly does not anticipate any agreement between the income sheet and the balance sheet. To quote from the same author, "You cannot eat your cake and have it too."[32] If the cost of the house is to be regarded as an expense—asset consumed in the production of revenue —it can hardly, at the same time, be regarded as an asset. You cannot logically conceive of assets consumed and at the same time existent. Income and the stock of wealth from which it flows are very closely related. Depreciable property gives rise to income, but in so doing it is itself sacrificed, in time. The capacity to earn income is assumed by Fisher to be the very source of its value, through the discounting process. Whether the capitalized value of future income is accepted as the true measure of the value of the property or not, it is quite certain that the value of the property inheres in its capacity to earn income. Even though this capacity is terminable, it does not follow that the capacity terminates with the creation of the property which has served to produce income for some time. It still has value in that it will produce still more income; but its value at that time will not be equal to its value new, by virtue of the discounting process. Thus the value of depreciable property disappears as its service life becomes less, not all at once. Depreciation is a real expense, cost is not at once an expense.

To insist that the cost of a depreciable asset is at once an expense (consumed in producing revenue), is to insist that money is the only property that has value. Money, by and of itself, has value largely because it can be freely exchanged for other forms of wealth. This, at least, implies that the things for which money can be exchanged are the

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[30] *The Nature of Capital and Income* (1906), p. 140.
[31] Supra, p. 124.
[32] Op. cit., p. 135.

real values. To exchange money for other forms of wealth surely does not, at the moment, involve a loss. The value disappears only as the property wears out or otherwise becomes less useful. If property depreciates without producing any returns whatsoever, then there is a real loss, if the property gives rise to income, the total returns from it must be more than enough to cover depreciation and all other expenses.

The Technique of Consolidation. Combining the gross revenues, expenses, and net income items of several enterprises so as to disclose the same items in terms of the transactions of the group, as an entity, with the parties outside the group, involves the technique of "consolidating" the several statements. Any procedure by which several statements are consolidated must especially provide against double or perhaps multiple counting. The technique of the accountant is almost above reproach in this respect.

Merely summing the items of the several members of the group will succeed in escaping the fallacy of multiple counting for net income if none of the transactions among the members of the group results in assets to be reported in the balance sheets of the members at the close of the accounting period. That is, if all of the intercompany transactions are either non-profit transactions or are transactions that result in revenues for some members and expenses for others, no multiple counting will be incorporated in the net income which is calculated from these summed items. Such a method of combining the income data would result in double counting for the intermediate items such as gross revenues, total expenses, and non-operating net income items. If one of the members sells, at a profit to another member, an item that constitutes an expense for the second member, the amount involved—the selling price—will be entirely eliminated from the net income of the second member and included in the net income of the first member, thus not appearing in the net income of the group.

The *summation of the net incomes* of the members of the group will accurately disclose the net income of the group as a whole, free from double counting, provided, as in the case above, there are no resulting assets at the close of the period that are the result of profit transactions among the members. Fisher refers to this method as the "*method of balances.*"

The accountant, however, does not employ either of the above methods in preparing consolidated statements for a group of affiliated enterprises. He employs what Fisher refers to as the "*method of couples.*" Both of the above methods requires that all of the profit transactions among the members of the group be entirely cleared from the accounts by transactions with parties outside the group. When, as is usually the case, goods or services that are exchanged among members of the group at a profit are still undisposed of from the standpoint of the group, and are to be included in the assets of any one of them, a more complicated technique is employed. Fisher, in explaining the "method of couples" does not assume that any assets of this nature are involved, his assumptions are entirely too simplified. The method employed by the accountant is usuable whether assets are involved or not.

Just how far the process of consolidating the financial statements of enterprises should be carried, in calculating the national income and the national wealth, is a question of no small importance. Certain aspects of the problem are largely academic, since data sufficiently comprehensive to carry the process very far are not available. If each individual were considered a separate enterprise in the business of producing goods and services for the nation, and if the income statements of all individuals were available, a complete and thoroughgoing job of consolidating them would disclose no saved income for the nation at all, except that realized from international trade. Much of the property values that we think of as perfectly legitimate values would disappear in such a scheme, because most of them are created through transactions among the people of the nation. Certainly the national income arrived at from any such procedure would not be the sort of income that is generally conceived in the expression "income,"

Should, then, the national income be conceived of as that involving no consolidations at all? The limits to which this concept would carry are difficult to comprehend. Should each department in a fabricating concern, involving the processing of the product in successive stages, be considered a separate enterprise, passing its product on to the next department with a profit included? Should each operation in the process book a profit before the product is passed on to the next? Obviously, any such scheme of accounting for income would accrue entrepreneurial income for individual processes before it could be determined whether the product as a whole consisted of valuable accretions to the individual parts purchased from others. Inventories would, as a consequence, be valued at hoped-for selling prices, less costs yet to be incurred. These are the limits between which the most useful concept of national income lies. As was pointed out above, the data necessary for either of these extremes are not available. In the present study, only data of operating electric light and power companies were used, so that the question of consolidating the statements was largely avoided. Undoubtedly some of the statements were consolidated, but for the most part sales and purchases among the electric light companies were considered legitimate transactions as reported.

The Accounting Technique Applied to National Income.

> Starting with these concepts of services [gross income] and disservices [expenses], the student of income can scarcely go astray if he will take the trouble to learn the ordinary bookkeeper's art of crediting and debiting. . . . The total net income from source *A* is the net sum found by adding together the values of all its services and subtracting the value of all its disservices.[33]

The accountant's technique is a "complete, consistent, and logical system" designed especially to cope with problems of income and its measurements. As a scheme to avoid double counting, it is infallible; it provides a sure method of checking the accuracy of its allocations as between capital and income, to avoid double counting, by correlating the changes in economic condition with the status of economic condition at the beginning and end of the period. Many of the problems that confront the student of national income have been met by the accountant and a workable solution formulated. The problem inherent in the periodic determination of income, including those of allocating revenues and expenses; the problems encountered in consolidating or combining several sets of data into one exhibit for the group as a whole; and the interrelation between income and property as complementary concepts have been translated, by the accountant, into a technique that is in its main outlines, universally employed in business and is perhaps better understood among people in general than any other method of exhibiting economic data. Yet in spite of these apparent virtues, it appears that no attempt has ever been made to employ the technique of accounting in estimating the national wealth and the national income as thoroughly interrelated studies.

There are, to be sure, some phases of the accountant's technique that must be applied, in studies of this nature, with caution. The technique of consolidation, for example, might seem to be particularly applicable to national income. But, as previously pointed out in this study, the national income is not commonly conceived of as only the income that the nation, as a unit, realizes from its dealings with other countries. Consolidation is a technique which is employed principally among affiliated enterprises, under more or less common management, where the community of interest is such as to militate against freely competitive dealings, and where inter-company profits may be the result of connivance rather than competition. The grouping of enterprises and industries for purposes of national income calculation, is an artificial grouping, community of interest is almost entirely lacking, the members are not operating under a closely integrated common ownership. Therefore the transactions and commitments among them are presumed to be based on competitive

[33] Fisher, I., *The Income Concept in the Light of Experience* (1927), p. 4.

prices and the profits resulting therefrom represent the value of the owners' contributions to the product. This sort of profit should not be eliminated by consolidation even though all enterprises are, in reality, owned in common by the individuals of the nation. The national income is, therefore, rather the combined incomes of the individuals of the nation.

In the matter of differentiating between expenses and distributions of income, the accountant's terminology does not suggest the true relationship, for purposes of national income. Some of the items that are expenses in accounting for business enterprises, are incomes for the individuals of the nations, as for example, salaries and wages. In fact, the net expenses, consolidated for all business enterprises, are incomes for individuals. All revenues of business enterprises are either expenses for other enterprises or income to individuals. Thus, if the incomes to individuals, that are commonly interpreted as expenses in business, could be segregated the other business expenses would be inter-corporate expenses and revenues, leaving only incomes to individuals. A simple summing of the income statements of enterprises will automatically eliminate all inter-enterprise transactions. The sum of the net incomes of the enterprises are incomes to individuals. Refer, for example, to the illustrations in connection with the preceding topic, "The Technique of Consolidation," page 65 ff. Assume that these three enterprises are the only enterprises in the country. The Total column is the summation of the income statements of the enterprises. The total revenues amount to $18,000.00 and, in a freely competitive situation, represents the expenses of the enterprises and the incomes of the individuals. In each case, if the wages are segregated from the other expenses, the resulting net income is the amount of wages and the other income accruing to individuals. If the illustration is made more complex by introducing inter-corporate security holdings, the problem is soluble. The typical income statement form usually requires that interest and dividend receipts be separately listed as net income items and they are segregated from the rest of the statement as distributions of income. Total interest and dividend payments for all corporations in the country would exceed total interest and dividend receipts by all corporations in the country by the amount of interest and dividends paid to individuals. The net interest and dividend payments of all corporations are the payments to individuals as income on the securities held by them.

What disposition or treatment should be accorded the net income, accruing on securities held by corporations, but not declared by the operating company as dividends? Eventually, the equity in the surplus is that of individual stockholders. The immediate equity may reside in some other corporation, but the equity of all corporations finally resides in individuals, so that the increase in surplus, in the final analysis, is net income to individuals immediately reinvested in the companies in which it was earned. Is the net income, accruing to these individuals, correctly reported as to the period in which it is earned and as to the company or industry through which it was earned? Although the final distribution of the income may be made by another company and in another period, the income is the result of services furnished in the current period through the operating company. The holding-company is simply an intermediate agent for the collecting of the capital and the distribution of the income. The net income is determined without respect to the time the income is distributed or the manner of the distribution. If the holding-company, on the other hand, were to accrue the income on the securities held by it, there would result a case of double counting, once by the operating company and again by the holding-company, of the income. The practice of accruing undivided income on stock held by corporations is not considered good practice, although the Treasury Department permits dealers in securities to value their securities for income-tax purposes at market, a species of income accruing.

What treatment should be accorded the speculative gains and losses realized from trading among individuals in securities? It

is obvious that these sorts of transactions cannot increase the national wealth, hence the national income cannot be affected thereby. Whatever one gains the other loses. The whole thesis of the accountants is that a constant adherence to actual costs is the only scheme that will accurately disclose income. The fact that an individual pays $125.00 for a security that represents an equity in property controlled by a company to the value of $110.00, does not increase the national wealth by $15.00. The wealth is only *evidenced* by the security and it consists of property held by the corporation. The above transaction simply simmers down to the fact that the buyer of the security gave the seller $15.00 of his property, call it income to the seller, perhaps, but if so it is as surely a loss to the purchaser. The two together have the same total property they had before, that is $125.00 in cash and $110.00 in property held by the corporation.

The Government in its Relation to National Income. In estimating the national income produced, the entire business of the nation may be classified into rather large groups or industries. In classifying all the financial dealings of the peoples of the United States into industries, the status of the local, State, and Federal Governments must be clearly defined. Is the government, like any other industry, in the business of selling goods and services at a price, or is the government simply a spending agent for the individuals? In so far as the taxes levied are prices paid for protection or assistance to the industry, the tax is clearly an expense to the industry and the government may earn an income. In so far as the tax money paid by an industry does not pay for services rendered to the industry, but instead, goes to pay for government services rendered directly to individuals, the tax is not an expense of the industry but a form of income indirectly distributed to individuals, and the government cannot earn an income. The question is one of determining the point at which the income is earned. Is the income earned through the agency of the tax-paying industry, or is the government an agency through which some of the national income is earned? Some of the levies made by the government may be of a quid pro quo character; it is certain that many of the taxes paid by industry have little or no relation to the amount of benefit received in return. Pensions and bonuses paid by the Government, such as soldier pensions and so on may be regarded as distributions of income for services rendered to business in protecting the advantages, if any, of our national integrity. As such, the taxes levied for this purpose are expenses to enterprises paying the tax. Interest on the Government debt is often of a similar nature. The line of demarcation is impossible to draw in practice. Other students of national income in the United States have generally regarded government as a separate industry and counted tax payments as expenses to the payor. The Federal Trade Commission, *National Wealth* and Income (1926), however, treated Government as a "partner in industry," and consequently, the taxes paid as distributions of income.

Government-operated industries, such as municipally-owned water works, gas plants, and electric light and power stations, do in all probability earn some income for the people of the nation, as the term "income" is generally conceived. The prices charged by these municipally-owned enterprises are not always comparable to those charged by private enterprise for the same service and for that reason privately-owned and publicly-owned utilities should be in separate categories for purposes of estimating the national income and the national wealth, whether or not all governmental operations are considered as a *separate* income earning industry. This study treats Government as a separate industry.

The Banking Dilemma. Banks and other financial institutions lending funds to industry give rise to some problems, in the final consolidation of the income statements of all industries in determining the national income as a whole, that are peculiar to their capital-raising function. Since the major portion of their earnings are in the form of interest and dividends their net value-product, estimated in the manner outlined in

this work, would be a negative amount. The revenues from sources other then interest and dividends are obviously inadequate, in the typical case, to cover payments to other industries, depreciation, and the other items included in "operating expenses" in the national income. The national income earned would likewise result in a negative amount if the formula advocated above is consistently adhered to in the statement of national income earned in the banking industry. Interest and dividend earnings are typically more than the amounts accruing to others as salaries and wages, interest, dividends, and additions to surplus. The "dilemma," of course, is due to the fact that interest and dividends paid to financial institutions are included in the net value-product of the industries using the funds. The earned income of these other industries, under the headings interest, dividends, and net income reinvested, also include incomes accruing to these financial agencies. In order to complete the consolidation of all of the industrial groups into a statement of income produced by the people of the nation, the interest and dividends accruing to financial institutions from other industries must be deducted from the sum of the net value-products of all other industries. Likewise the same amount must not be included in the earned incomes accounted for in the other industries as well as in the banking industry, or double counting will result. The amount involved is earned in the industries using the funds and accounted for in the industries lending the funds. It would be illogical to contend that the banking industry was simply a trustee for the depositors and that the interest and dividend payments made to banks can be counted as though they were paid directly to individuals. Not all of the gross revenue (interest and dividends) of banks is paid out at once to the depositors, much of it is paid as wages and salaries and thus not property income at all, and some of it is saved and reinvested in the banking business.

Professor Morris A. Copeland[34] suggests that "We may call this 'value added in banking' and deduct it from the property incomes of other groups as the price of banking service." The amount, he points out, is the total income from loans and investment in other industries, exclusive of that accruing on the proprietary equity so invested, less the cost of obtaining these funds, i.e., interest paid on deposits. In other words, the excess of earnings on depositors' funds less the price paid for the use of these funds, is the charge made to other industries for the service of banking. This service charge, he thinks, might be apportioned among the industries "on the basis of equities held" by the banks or it might be deducted from "total property income without attempting to apportion it among the several industry groups." It would be difficult to allocate this charge as between interest and dividends paid by an industry as a deduction from income realized in that industry. However, a blanket deduction from the earned property incomes of other industries allows this item to be counted in the income earned in the banking group and avoids double counting without seriously vitiating the estimates for any one of the other groups.

[34] Copeland, Morris A., *Some Problems in the Theory of National Income*, The Journal of Political Economy (February, 1932), p. 21 ff.

THE ACCOUNTING EXCHANGE

Technical Preparation for the C.P.A. Examination

Many volumes have been written covering the material which must be studied and reviewed in preparation for sitting for the C.P.A. examination. Suffice it to say that the only intelligent preparation for such an examination requires the most complete study and review of accounting theory which can possibly be undertaken. Much less material is available, however, on the technical preparation for the culmination of many months of hard labor and sacrifice. And yet many candidates have lacked the few points necessary to raise a 71, a 72 or a 73 to grade 75 simply through lack of such technical preparation.

First of all, the candidate should be thoroughly sure in his own mind of the strategy to be employed before he starts. This refers to the entire examination as well as to the individual problems. For the nervous indiviual a relaxation period of five minutes may be desirable before starting to work. Five minutes of gazing into space with the examination papers upside down on the table is a marvelous test of self-control, and provides opportunity for the nervous candidate to realize that this examination is given twice a year, and can be taken in many states twice for the same fee. He is then in a much improved position to exert every effort logically and directly towards the achievement of his Great Desire.

Some instructors advocate attacking the examination problems in order as they are presented, rigidly allotting time to each in ratio to the number of points. It is believed that a more logical approach is to scan the entire examination, to decide which problems can be worked the most easily, and then to solve in the order of the easiest first. This method permits acquiring the greatest possible number of points in the shortest space of time and tends to encourage that self-confidence which is invariably a requisite in a successful candidate. In many instances where the candidate finds himself short of time to complete the examination, he will be stopped in the middle of the hardest problem but probably only after he has done sufficient work to indicate to the examiner that he understands the points involved and is proceeding to a correct solution. The chances of achieving a passing grade are believed to be better under this method than they would be by attacking the hardest problem first and never getting even that problem completed.

Actually, rigid training for the C.P.A. exam should be started in the elementary accounting courses. Much of the technique which must be taught in the "C.P.A. review" course should have become a matter of routine and habit to the student long before he reaches that stage. This is particularly true in the case of statement technique. It is just as easy to prepare a professional appearing job as one rankly amateurish, and such training should be given in the first courses studied. A good technical job on financial statements will probably create an impression of competence with the examiner which will require much poor work in theory to eradicate entirely.

A review and discussion of certain points of technique essential to the preparation of financial statements in good form may be of value.

General

1. Never abbreviate on formal statements. The balance sheet, profits statement, and so on are just as formal as wedding or birth announcements and one would certainly not consider issuing announcements that "Miss Brown and Mr. Jones will be married on Wed., Dec. 31, 1935."

2. Never head a statement "For the Period Ending December 31, 1935." Such a caption without specifying the length of the period involved, be it day, week, month or year, is of little value in properly describing the statement which it heads.

3. Do not show any unexplained figures or totals. If figures with little significance are absolutely unavoidable, at least they should be captioned "Total" or "Net." Also, it is poor practice to show the total for a column

of figures opposite the last figure in the group necessitating reading from the top of the group to the bottom to connect the total figure with its proper caption. To avoid any possibility of misunderstanding on the part of the lay reader or the executive who is not an expert accountant, and to make the statement more informative, every figure should have some caption.

4. The heading of every statement should include at least three items of information, namely, name of the company for which the statement is prepared, title of statement, and the date as of which the statement is prepared or the period covered, as the case may be. If subschedules are prepared to support condensed figures used in the principal exhibits, such subschedules should have complete headings also.

5. Although it is desirable to adhere strictly to the terminology of the classification of ledger accounts in internal accounting procedure, captions and descriptions which will convey in the clearest and most explanatory fashion the significance of the figures involved should be employed in preparing statements for executive use or public consumption.

6. It is not desirable to leave unrequired space between items or sub-divisions of statements. A reader not versed in accounting procedure might wonder if some item were not omitted through error.

7. Statements should always be condensed so that they can be presented on one sheet of paper. A busy executive does not care to be constantly turning from one page to another in order to secure a complete picture of that phase of the business represented by the particular statement. The use of condensed figures supported by subschedules is desirable where statements involving large volumes of detail are prepared.

8. The prime purpose of variation in margins and underlining is to differentiate as to the relative importance of the various items appearing on the statement through an appeal to the reader's vision as well as to intelligence and accounting knowledge. Consequently, all major captions, such as division headings, should be started from the left-hand margin of the statement. Obviously the left-hand margin, towards which attention is first directed by any reader, is the margin of emphasis.

Neatness in margins and underlines will probably do more to "dress up" a statement and create the impression of professional ability than any other single thing. Margins should be of sufficient size to be well-defined and should always be even and vertically straight—*not* wavy or slanting. Writing should start *at* the margin line—not somewhere in that general vicinity.

A rule which is followed by many accountants requires that figures corresponding to captions at the left-hand margin be placed in the right-hand money column, captions indented one space correspond to figures in the next-to-the-right-hand money column, and so on.

Many accountants instruct their typists to copy all captions that are underlined on the pencil copy in upper case type. This seems to be a desirable practice to follow and provides a good rule for underlining in preparing pencil copy, namely, that all important captions and headings must be underlined.

9. The use of a ruler or straight-edge of some sort is strongly urged. In the examination room a heavy blotter may serve the purpose and prevent the possibility of much noisy handling of rulers.

10. The tendency of some students to crowd a statement on a sheet of paper that is not quite large enough for the purpose is to be deplored. Paper is one of the most inexpensive utensils with which the accountant has to work, and the effect of an expensive education should not be spoiled in an endeavor to save a piece of paper costing a fraction of a cent.

11. Dollar signs should be inserted wherever necessary. The typist will usually copy exactly what has been prepared.

12. A colon should be inserted immediately following division headings or other captions which are amplified or explained by subsequent figures. The colon in the language of the accountant means "detail follows."

13. Double underlines below the last

figures on each statement are an absolute necessity. They are the accountants' symbol for *C'est fini*, and until they have been inserted the statement cannot be considered complete.

14. The practice on the part of some candidates of preparing statements "in the rough" and then recopying to a final draft is to be deplored. An accountant meriting a C.P.A. degree must be able to think concisely and clearly enough to go about the job in a logical and orderly fashion and make his first copy the final draft. In any event, lack of time will prohibit preparing two drafts and such practice must become a mere matter of habit long before the examination can be successfully attempted.

Balance Sheets

The following points on statement preparation pertain particularly to Balance Sheets:

1. Never caption a statement "Balance Sheet for the Year Ending." A balance sheet is always presented *as of a given instant of time* and to indicate that it covers a period of time is grossly erroneous.

2. Where only one item appears in any subdivision it is superfluous to show either a division caption or a "Total" figure. The description of the item should be placed at the left margin and the amount in the column in which the division total would ordinarily be placed.

3. Insertion of the specific captions "Total Current Assets" and "Total Current Liabilities" is desirable to emphasize the working capital figure and current ratio of the Company.

4. If the current items on the balance sheet are of major importance and are to be shown at the top of the statement, then to be consistent (consistency should be one of the greatest virtues an accountant can acquire), the current assets and liabilities should be listed in the order of most current to least current. This will usually require that cash be shown first and inventories last among the current assets.

On the other hand, if fixed assets are of such major importance in the particular business that they are shown first on the statement, then the order of current items should be reversed, current assets reading from inventories first to cash last.

5. On the theory that any definite routine is better than no routine in accounting work, and because in the majority of instances such procedure will result in emphasizing to the reader the most important item first, it is recommended that fixed assets be generally listed in the following order:

1. Land
2. Buildings
3. Other equipment in the order of its monetary value

6. Unless some definite reason can be shown for a contrary procedure, it is recommended that valuation reserves be deducted from their related assets. The evolution of a net figure for such assets is believed to be desirable, despite the fact that many large corporations do not follow such procedure. In deducting the reserves from their related assets, it is not necessary to repeat the full name of the reserve account unless there is some reasonable doubt as to which asset is covered thereby.

7. Intangible assets such as goodwill, patent rights, leaseholds, trademarks, and so on, should be segregated from the tangible assets. The statement reader will usually be interested in knowing what proportion of the total assets is composed of intangibles.

8. It is desirable to segregate all figures of equivalent values in the same money columns. For example, many candidates show the detail of current assets and the total of that division in the same money column. The detail of other subdivisions appearing below the current divisions cannot be conveniently shown in the same column, resulting in an inconsistency in practice which is not at all desirable.

9. Despite a generation of practice to the contrary, it is strongly advocated that the net-worth analysis which support net worth figures used on the balance sheet be shown as a separate schedule or at the bottom of the profits statement. Inclusion of an analysis of net worth covering a period of time on a

balance sheet constructed as of a moment of time is inconsistent, and the advantage of disclosing extraneous items on the profits statement although they should not affect the net profit figure, is considerable. A cross reference should be provided in the balance sheet specifically indicating where the analysis to support the net-worth figures used can be found.

10. On account form balance sheets, the grand totals should always be directly opposite each other. The statement should be balanced physically as well as mathematically.

Profit and Loss Statement

1. Never caption a profits statement "Profit and Loss Statement December 31." Such a statement covers a period of time and this fact together with the specific period covered should be disclosed by the statement heading.

2. Inasmuch as a profits statement covers a period of time, and the inventories at beginning and end of the period are both essential to its construction, it is desirable to indicate the specific date of both inventories to eliminate any possibility of confusion.

Aside from the use of good technique in preparing financial statements, other exhibits are oftentimes required in the solution of C.P.A. problems which can be designed to give the impression of professional ability and efficiency on the part of the candidate.

Journal Entries

1. Only *one* transaction should be recorded by any one journal entry. Compound journal entries were invented to record single transactions involving several accounts, and not for the purpose of facilitating the consolidation of an entire year's transactions into one. The great danger in consolidating several transactions into a single journal entry, is that the transactions will not be clearly and completely recorded, and it is believed to be better to err on the side of of being over complete.

2. The same theory expounded in (1) should be employed when writing journal-entry explanations. Candidates are only too prone to consider a journal explanation such as "Depreciation for the period" sufficient, when in reality complete details supporting the entry, such as value on which depreciation was computed, rate of depreciation employed, and specific period covered, are all essential to the complete permanent record which should be reflected by the company's books. If the candidate will bear in mind the fact that the journal entry is the original record of the transaction which will be indefinitely preserved, and that the journals should provide a complete picture of the business if every other record of the company were destroyed, considerable improvement in the technique of writing journal entries will be assured.

3. Many problems have as their sole requirement the preparation of journal entries. The ease with which some single entry essential to a correct solution can be omitted, renders desirable the hasty posting of such entries to rough T-accounts to prove the accuracy of the entries.

Working Papers and Computations

1. Do not waste time by setting up unnecessary working papers. It will be found that extensive working papers which were formerly considered essential to the solution of such problems as these requiring statements of application of funds and consolidated balance sheets can be eliminated by the employment of a little ingenuity on the part of the candidate.

2. Computations requiring the use of fractions or decimals should be carried out a sufficient number of places to eliminate any material error in the final answer.

3. Regrettably, the "human error" element seems to be present in a major degree in many candidates. Such candidates should recognize their own weaknesses and recheck all computations to avoid mathematical errors. There is no trick method for avoiding such errors—each candidate is personally responsible for his own work in this respect, and only as he accepts such responsibility and takes the necessary steps to verify his own work can he hope to be successful as an accountant.

4. In problems such as the tax-and-bonus type, which require the use of algebra, it is very desirable that the answer be proved after it is ascertained. Possible errors of mathematics and in method will both be found if this is done.

5. The examiner will undoubtedly appreciate the segregation of the problem requirements from any detailed working papers which may be involved in the problem solution so that he can locate the required schedules without an extended search. If each candidate could perform a little impersonal scrutiny of his own work he would probably appreciate the pertinence of this comment.

Answers to Questions

1. Unsupported assertions are practically worthless. The reasoning leading to the conclusion stated should always be given. In many cases, but two guesses as to the correct answer are possible, and the examiner should never be permitted to wonder whether this was the method by which the solution was evolved by the candidate.

2. Be concise and yet complete. Achievement of this objective may require years of practice, and at the same time prove one of the accountants' most valuable assets. Many students who can talk fluently are utterly unable to express themselves comprehensively in writing. It is suggested that the style in some good text be studied and imitated in so far as possible. Then the candidate should reread what he has written, impartially and critically, to see if it is grammatically correct and smoothly expressed. Constant training should be given from the time the candidate commences his study of accounting in order that proficiency in expression will be natural and automatic.

3. The examiner is interested in what the candidate *knows*. Many times students are wont to preface their answers to questions by saying "I think such and such is correct" or "I imagine it should be so and so." Such practice is to be deplored. The examiner will respect an honest opinion although it may be entirely erroneous, much more than a correct one half-heartedly expressed.

General

1. *All* the requirements of a problem should be answered *exactly as they are stated.* The candidate may think he knows better than the examiner as to what was in the examiner's mind when he set a certain requirement, but it is never safe to gamble on the fact. Certainly the candidate cannot be criticized for evolving a solution strictly in accordance with the letter of the requirement. He can always qualify his answer if reasonable doubt exists.

2. Facts or figures should never be supplied when they are not found in the problem. For example, depreciation or interest factors are many times omitted from problems. Admittedly the problems are impractical on such points, but the candidate should never attempt to supply interest or depreciation rates that are missing. He should simply qualify his solution to indicate his recognition of the omission.

3. Where more than one method of procedure is possible in solving a problem the candidate should proceed on the basis which he believes is best and state his reasons for so believing. It is not necessary to describe all of the possible assumptions on the particular point since the statement of one assumption indicates that the candidate is aware of other possibilities.

4. Where computed figures are required in problem solutions, some sort of schedule covering the computation should be shown. This refers to such computations as interest, goodwill, and so on. If only the answer is submitted or used, and that answer is incorrect, the examiner has no way of determining whether the error was one of principle or simply mathematical. Errors of principle detract much more from the value of a paper than mathematical errors, but if no evidence to the contrary is provided, the examiner is only warranted in assuming that the error was one of principle and grading accordingly.

5. If time is insufficient to finish a problem, the candidate should spend the last few minutes of his time in writing a short résumé of what he would do to complete it. Some credit must be allowed by the examiner for

such a description, and this credit may make just the difference between success and failure.

A complete mental rest for the C.P.A. candidate is recommended for several days before sitting for the examination. If several years of concentrated study of the subject have not provided a sufficient preparation, it is obvious that two or three days' work cannot complete the job. Last minute "cramming" is always confusing.

The writer's recipe for success in the C.P.A. examination can be briefly stated. A complete theoretical preparation, a conscientious technical preparation, a clear head and an alert mentality, a dash of self-confidence, plus plenty of intestinal fortitude—these should spell C.P.A.

HOWARD F. GREENE

A FEDERAL INCOME-TAX CHART FOR 1936

The accompanying chart (page 407) has been devised as an aid in visualizing the effect of the rates of income and excess-profits tax applicable to corporations for fiscal periods ending after November 30, 1936. A new declared value for capital stock and surplus is to be made as at June 30, 1936, and because the rates of excess-profits tax have been increased from 5% (the present rate) to 6% and 12%, the minimum amount at which such value should be declared warrants careful study.[1] Each $1,000 of declared value will be taxed at $1.40; a failure to declare the necessary minimum means an excess-profits tax at $6 or $15[2] for each $1,000 deficiency of declared value.

The chart defines the various brackets (4 normal-tax and 3 excess-profits-tax brackets) in which the possible combinations of income and adjusted declared value will fall. In each bracket appears a formula from which the computation of the total tax may be made. Vertical lines represent adjusted declared values in thousands of dollars; horizontal lines, the ratios of net income to adjusted declared values.

To determine the total tax. Find the ratio of net income (I), before deduction of income or excess-profits taxes, to adjusted declared value (C), and locate the point of intersection within one of the 12 brackets. Compute the tax from the formula appearing in the bracket. For ratios greater than those on the chart, apply one of the four top formulas according to the amount of income. For adjusted declared values greater than $500,000, it may be assumed that the limits of the two nearly horizontal lines (which begin at the left of the chart at .17143 and .11428) will not exceed .17648 and .11765, respectively.

Example: Assume an adjusted declared value of $200,000 and a return thereon of $50,000, or 25%. The point of intersection of the ratio and the adjusted declared value indicates that the formula .252 I−.015 C −492.80 will apply. Substituting the values given for I and C: $12,600−$3,000−$492.80 =$9,107.20, the total income and excess-profits tax.

To determine minimum capitalization. For any given estimate of net income the minimum capitalization (i.e. adjusted declared value) necessary to avoid the excess-profits tax may be ascertained. The lower nearly horizontal line marks the beginning of that tax. To escape that bracket, the intersection of the income ratio and the adjusted declared value must not come above the line. The values of this line in terms of adjusted declared value are as follows:

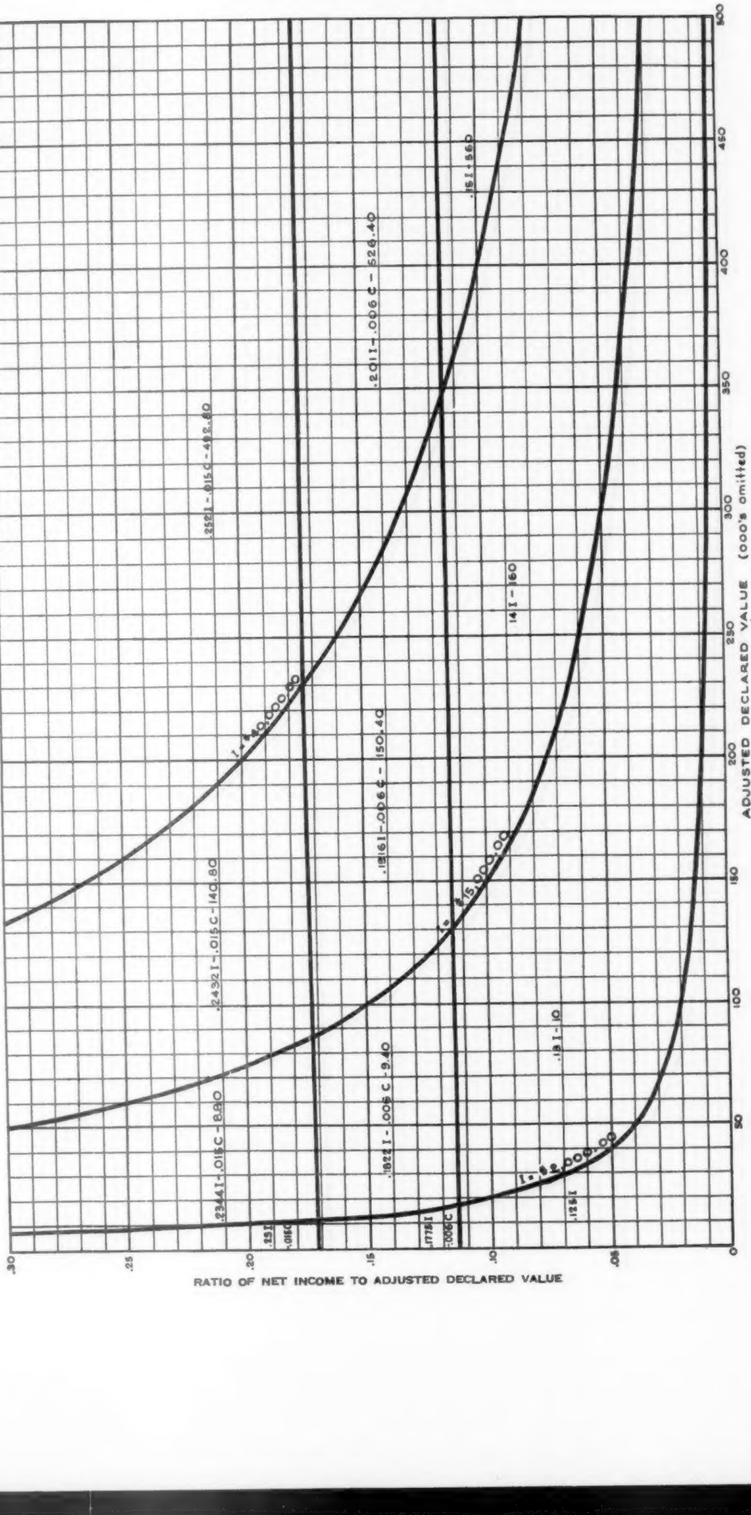
Income Range	*Minimum Adjusted Declared Value*
Less than $2,000	8.75 I
$2,000−$15,000	8.7 I+$100
$15,000−$40,000	8.6 I+$1,600
More than $40,000	8.5 I+$5,600

Example: An estimated annual net income of $10,000 would call for an adjusted declared value of not less than 8.7 times that figure plus $100, or $87,100; should income be estimated at $50,000, an adjusted declared value would be required of not less than $425,000 plus $5,600, or $430,600.

E. L. KOHLER

[1] Sections 102, 105–6, Revenue Act of 1935.

[2] These values may be read from the formulas on the chart.



FEDERAL INCOME-TAX CHART FOR 1936

BOOK REVIEWS

The Use of Statistical Techniques in Certain Problems of Market Research. Theodore Henry Brown. (Boston: Bureau of Business Research, Harvard University. 1935. iv, 24 pp. $1.00.)

This publication contains five illustrations of the application of sampling theory to problems of market analysis. It is clearly written so that the reader should have no difficulty in seeing the problems or following the solutions. The illustrations are generally well chosen.

The contents may be best suggested by quoting the first illustration.

The Parker Company, which manufactured toothpaste, had engaged an agency to investigate the market for its product. Because of the expense involved in a census, the agency planned to base its conclusions on a sample which would represent the character of consumer demand for toothpaste. In the report submitted to the company, the agency included a table which indicated the number of users of paste in comparison with the number of users of other types of dentifrice, such as liquid or powder. These data were as follows:

TABLE I. PREFERENCE FOR TOOTHPASTE

Users of Toothpaste..............	2,768	69.2%
Users of Other Forms of Dentifrice..	1,232	30.8%
Total Replies to Inquiry.........	4,000	100.0%

From a study of these data it seemed to the research director of the Parker Company that the users of paste represented a decided majority of the consuming public. He recognized, however, that another sample might give quite different results. Doubt as to the certainty of the interpretation raised the question whether there might not be some way of measuring the error in the percentage of the users of paste as indicated by the sampling results shown in Table I. It was this error in the percentage which the research director of the Parker Company desired to know.

It is then shown that the odds are 100 to 1 that the percentage of the population preferring toothpaste lies between 67.1 and 71.3 or rather the inference is drawn that the errors of simple "random sampling" would be within these limits.

There is ample evidence that researchers in the field of market analysis have often neglected the technique described in this publication. Their conclusions have often been based on inadequate numbers. Consequently a study of this type is salutary even though it adds nothing to the theory of sampling.

By way of criticism, the reviewer would like to have found a more complete warning that a unique sample does not guarantee absence of bias even though the sample is large enough to satisfy the tests given. There is no substitute for repeated experiment, or in these cases, repeated sampling. If another sample of the same size had shown a much larger proportion of persons preferring toothpaste over other dentrifices, far from strengthening the conclusion it would have weakened it. This paradox is explained by the presence of uncontrolled circumstances attending the sampling process and is wholly consistent with the theory of random sampling. The practical man has in mind just these uncontrolled circumstances when he thinks of "chance" and is not likely to be convinced by the inferences drawn from random sampling as it is visualized by the mathematician.

O. W. BLACKETT

University of Michigan

Expenses and Profits of Variety Chains in 1933. Malcolm P. McNair. (Boston: Bureau of Business Research, Harvard University, 1934. Pp. iv, 35. $1.00.)

This bulletin presents, from a sample composed of more than 80 per cent of the industry, figures for gross margin, total expenses, classified, and net profit in variety chains in 1933. Some of the valuable features of the bulletin are a comparison of the results for 1933 with the results of 1932 on the basis of identical companies reporting for both years, and "goal" figures which represent the operating results of the most profitable firms. In addition, comparisons are made of the operating results of variety chains on the bases of the types and number of stores operated, volume of sales, size of average sales per store, rate of stock-turn, and population of the cities in which the stores are located.

The bulletin is particularly interesting because of the conclusions that are derived from the data: Approximately seven-eighths of the costs incurred by a variety chain, except interest, are for the immediate operation of the stores. Since operating costs, except interest, average 30.84 per cent, it is evident that most of the savings in distribution by variety chains are secured in the central office by the integration of the retailing job with some parts of the wholesaling job.

The most profitable group of variety chains is that with the highest percentages of gross margin. This profit, in part, is secured by taking advantage of the unusual price movements in 1933. The most profitable chains are characterized by high average sales per store. The high average sales require a good store location in cities with populations of over 10,000. Furthermore, such a location results in a low total operating cost in spite of a high rental expense, and is apparently the prime requisite for outstanding success in the operation of a variety store. On the other hand, low-profit chains are largely chains with a high percentage of expense. They are, in general, chains with small sales volume and a small number of stores.

One section of the bulletin is devoted to a study of the rate of stock-turn in relation to expenses and profits. The conclusion reached is that "it does not appear that in the variety chain business any peculiarly transcendent virtues are to be ascribed to a fast rate of stock-turn as such."

Some interesting facts are stated in respect to certain operating policies of variety chains: Typically the variety chain companies bought 90 per cent of their merchandise directly from manufacturers. Any special reductions in purchase price were secured as open price reductions, since discounts and allowances were only 1 per cent of sales. Variety chains suffer very little from mark-downs and stock shortages, as is evident from

the fact that the typical reductions from these causes were less than 2 per cent of sales. It should be noted, however, that periods of rising prices, such as occurred in 1933, are typically periods of low mark-downs and stock shortages, since additional mark-ups are frequently used to offset mark-downs and stock shortages.

Professor McNair and his associates are to be commended for their series of studies in the variety chain field. They have brought to light and given quantitative measurement to many of the characteristics of variety chain operation. The studies, however, have covered a period of great economic unrest. In 1932 we had the full downward sweep of the depression; in 1933 came the banking crisis and a rapid rise in the price level occurred. These abnormal conditions have so affected expenses and profits that it is not possible to know the extent to which the conclusions drawn from the statistical data for 1932 and 1933 have a long-run significance. It is hoped that additional studies may follow that will give an analysis of the expenses and profits of variety chains under more normal conditions.

EDGAR H. GAULT

University of Michigan

Retail Price Behavior. John H. Cover. (Chicago: University of Chicago Press, 1935, Pp. viii, 92.)

This study was made "in the hope of determining a basis for the more adequate collection and analysis of retail prices," and "to propose an organization and procedure for collecting and analyzing prices."

The study was made by Prof. Cover at the request of the Committee on Government Statistics and Information Services appointed by the American Statistical Association and the Social Science Research Council at the request of the Cabinet. The work was done with the assistance of the Federal Interdepartmental Committee on Retail Prices made up of experts from various government departments. Most of the data was gathered as CWA projects in Minneapolis, St. Paul, Mankato, Winona, and Hibbing, Minn.; New York; Washington; and Atlanta. The data were analyzed under the sponsorship of the University of Chicago.

The study is interesting both for its development of methodology and also for the findings in the cities covered.

The first problem was the selection of commodities. Farm, office, and school equipment; building materials, books, and periodicals were excluded. Prices of 631 commodities were gathered including food, clothing, drugs, toilet articles, confections, tobacco, electrical and household equipment, stationery, sporting and optical goods, leather goods, petroleum products and anti-freeze solutions, tires and tubes, ice, and domestic fuels.

To secure comparable prices specifications or standards must first be adopted. The lack of such specifications has limited some past studies to staple or branded products. Drugs were found to be the most standardized of any line or products. Foods are also fairly well standardized with the exception of fresh meats. The lack of uniform standards for clothing has, however, limited price comparisons in the past. Specifications for textiles and clothing have now been prepared and are available in government files. It is pointed out, however, that changes in style and quality "make standardization of specifications of some articles impossible over a period of time." But basic measures such as thread counts may be used and from these measures variations may be observed. However, "it is not safe to assume that items quoted from time to time under given specifications are of constant quality, even though they continue to meet specifications as drawn. Slight changes are frequently made of which even retailers are not appraised. Because of rising price level, many recent changes have resulted in a decrease in quality of goods. . . . Emphasis must continue to be placed on the necessity of checking specifications at intervals with manufacturers and retailers."

The second problem is the selection of typical cities which will furnish representative prices. Regional differences depend on climate, local raw materials, size and congestion of community, race proportions, and local consumption habits. The grades or products sold often vary between towns. For example meat is sold in some towns with bone and in some towns with the bone removed. Few men's fur trimmed overcoats, fleece lined jackets, and women's heavy sweaters are sold in Washington and Atlanta.

The committee suggested 237 communities which would give an adequate sample of urban prices. These cities include various types of population, geographical areas, old and new communities, and satellite cities. Eighteen of these cities are suggested as headquarters where permanent staffs would be maintained. Food prices would be obtained at least monthly and clothing prices quarterly. Prices would be gathered synchronically in the 18 headquarters cities after which the staffs would move to the smaller cities. Methods are suggested for securing properly qualified workers, for their training, and their supervision.

No claim is made that the 8 cities included in this study are representative of the entire country. Nevertheless the findings are very interesting and throw light on some controversial subjects as, for example, prices in different types of stores.

Department stores do not claim to handle as wide a variety of quality and sizes as do specialty stores while chains stock more closely to definite grades, brands, and prices. On men's clothing, no significant differences in prices were found between department and specialty stores in New York but in Minneapolis and Atlanta the department stores had lower prices. On work clothing, department stores in New York and Minneapolis had higher prices while in Atlanta they had lower prices. Letting the prices of specialty stores equal 100, then the prices of department stores were 99 in New York; 91 in Minneapolis; and 83 in Atlanta. On women's clothing the department stores in New York had higher prices than the specialty stores while in Minneapolis and Atlanta they had lower prices.

On foods, in St. Paul in February, 1934, on 58 generally sold items, the chains were 1% under the independents while the coöperative chains were 4% above

the independents. In Minneapolis, chain food prices were found to be 4% under the prices of independents. In most of the former studies the chains have shown somewhat greater price advantages. One wonders if NRA has forced the chains to raise their prices or if the natural working of competition has enabled the independents more nearly to meet the prices of the chains.

With drugs, the chains had lower prices than both cash and service independents. The chains, however, operate largely in down-town locations where cut prices are much more effective in increasing volume than in neighborhood locations.

Downtown food stores had 8 per cent lower prices than neighborhood stores in Minneapolis and 2 per cent lower prices in St. Paul. In the Twin Cities, drug stores with no nearby competition had 1 per cent higher prices than stores with nearby competition.

It was found that the price of foods increased with the rent paid by the consumers in various neighborhoods. This relationship appeared to be fairly definite.

From February, 1933 to February, 1934, prices advanced approximately 11 per cent. The price of drugs dropped 5 per cent. Prices advanced most in Washington, 21 per cent; and least in Atlanta, 9 per cent.

To illustrate the differences in prices in the cities covered, the price of a given grade of men's suits in 1934, was $31 in Atlanta and Winona; $35 in Washington; $40 in Hibbing; and $42.25 in Minneapolis.

The reviewer found the subject matter of this study so interesting that he noted little with which to disagree. Minor errors can be found in nearly all reports. For example tables VI to X in the appendix give price changes between 1933 and 1934 but from the text (p. 38) it appears that the price comparisons are between February, 1933, and February, 1934 and not between the entire years as the headings indicate. Such minor errors are, however, few in number. The study seems to develop a plan for a larger study. One may, however, raise the question of whether the larger project outlined here would be worth its cost. If such a plan were undertaken as a permanent project, it might well develop that fewer than 237 cities would give price changes representative of the country. The entire number might, perhaps, be priced only occasionally to obtain data on geographical differences in price.

Paul D. Converse

University of Illinois

Wholesale Accounting and Control. J. Brooks Heckert and Irving J. Stone. (New York: McGraw-Hill Book Company 1935. pp. x, 234. $3.00.)

Teachers of accounting have long felt the need of books dealing more adequately with the more important special phases of accounting than they have commonly been able to get in books on accounting systems. Slowly these needs are being met. This text is an important contribution in this field. It is sufficiently technical to be of real use to the controller of a wholesale organization, yet sufficiently general to be valuable for the general student of accounting and administration.

The first seven chapters are concerned with the general outlines and the significant detail of the accounting system for wholesalers. The last chapter of this group is entitled "Allocation of Functional Expense to Operating Departments." The suggestion of several alternative methods, with pertinent discussion of the situations in which each may be applicable, adds to usefulness and adaptability.

The remainder of the book deals in the main with problems of control. Chapters 8 to 13 are devoted to the analysis of general and departmental reports, to the analysis by individual lines, by orders and customers, and by salesmen and territories. Necessarily, procedure occupies an important place, but it has not been at the expense of a discussion of the use and significance of ratios. Chapter 12 is devoted entirely to the problem of setting up standards wherever possible, with which the actual results may be compared. This is entirely in harmony with the recent tendencies.

Chapters on budgeting, the control of sales, selling expense, operating and general expense, accounts receivable, inventories, and broken packages follow in that order. The importance of these problems has long been admitted, but their application to specific industries often involves real difficulties. In these chapters detailed discussion, often including charts and forms, shows the extent to which these controls may be developed by the wholesale house.

Two final chapters on special problems and the functions of the controller conclude the main body of the text. An interesting and pertinent appendix on the distribution costs of wholesale druggists and operating results of wholesale grocers concludes the volume. These studies are based on investigations made by the National Wholesale Druggists' Association and the studies made by the Bureau of Business Research of Ohio State University.

This book is logically organized and well written. It should make for itself a useful place on the shelves of the practicing accountant, the teacher, and the accounting executive of the wholesale concern.

Willard C. Beatty

Brown University

How to Analyze a Bank Statement. F. L. Garcia. (Cambridge: Bankers Publishing Co., 1935. Pp. 54. $1.00.)

In view of the recent trend toward greater detail in bank statements, Mr. Garcia's up-to-date treatment of analytical methods should prove of value to all interested in statement interpretation. In addition to a discussion of the accepted methods of balance sheet analysis the book includes methods of analyzing earnings statements for use where such data are available, proper attention being paid throughout to the effect of recent factors such as the issuance of preferred stock or capital notes to the Reconstruction Finance Corporation and the insurance of deposits under the Federal Deposit Insurance Fund. Included also is a set of tables giving significant average ratios of member banks of the Federal Reserve System for the period 1919–1934, which are an important interpretative aid in the study of an individual bank's statements of condition.

Quite properly, Mr. Garcia warns against bank statement analysis along purely statistical lines. Such a procedure "can at best be only a quantitative survey of condition," and a consideration of various "intangible" factors is recommended. If due regard is paid to the latter, however, the analyst will find the methods presented in this book quite helpful in the interpretation of bank statements.

R. D. REINHARDT

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Accounting Evolution to 1900. A. C. Littleton. (New York: American Institute Publishing Co., Inc., 1933. Pp. xi, 368. $5.00.)

As Dr. Littleton states in the preface, this book is not a history of bookkeeping or accounting, but reconstructs briefly "the long evolutionary struggle to devise and perfect a tool of expression and measurement (proprietary double-entry bookkeeping)" and sketches "the circumstances surrounding the expansion of simple clerical or bookkeeping processes" into accountancy.

The development of accounting has been closely related to progress in industry and changes in economic conditions; it has been relative to Society's own development. Records of receipts and disbursements appeared early, in Egypt, Greece and Norman England, and personal accounts or personal memoranda of indebtedness have been kept in informal ways in all ages. The heads of Roman families were required to keep domestic accounting records, originally containing entries of cash received and paid but later involving debts as well. Special books of account were also maintained to keep track of the investments of surplus funds of wealthy Romans. These early records, however, bore little similarity to bookkeeping as we now know it. It was not until commerce began to revive in the Italian trade cities, after the Dark Ages, that the keeping of personal accounts was extended into trading operations. These operations, in their early stages, consisted of a series of joint ventures, and the records were those necessary to enable the agent or active partner of a specific adventure to report intelligently upon his activities. Later trading developed into a permanent business instead of a series of joint ventures, and it was then that modern double-entry bookkeeping began to emerge.

Continuing investments of capital and periodic reporting of results of business operations brought the need for differentiation between proprietary capital and proprietary profits, and the function of modern account-keeping is to measure and explain the tangible results of the ownership of capital and its dedication to gainful activities. The essentials of bookkeeping as we know it today were contained in the first printed work on the subject by the Franciscan monk, Luca Paciolo, and published at Venice in the year 1494. Since that date there has been little basic change in bookkeeping; in over four hundred years we have added a body of theory but have contributed little to the practical side other than the technique of auditing, cost finding and budgeting.

From the fifteenth to the eighteenth century commerce consisted principally of trading, and there was little occasion for changes in methods of account-keeping beyond the procedures outlined by Paciolo. With the industrial revolution and the coming of large-scale manufacturing and industry, however, bookkeeping entered upon an era of marked expansion necessitated by the increasing complexities of modern business organization and operation. Such factors as cost and depreciation became increasingly important. Development and expansion of corporate organizations had a great influence upon bookkeeping, not only by reason of such factors as size, number of persons associated with the enterprise, lack of personal contact of stockholders and outside control, but also because of the theory that a corporation is a continuing enterprise involving long-lived investment from which periodic returns will flow. The separateness of the corporate entity and limitation of stockholders' liability for corporate debts result in the obligation to preserve invested capital intact and necessitate accurate determination of profits. "The power of expressing the difference between capital and income is one of the basic characteristics of double-entry bookkeeping, and the accurate computation of the actual periodic income is one of the chief functions of accounting. So far as the corporation made such a distinction in elements increasingly important, just so far it stimulated the expansion of bookkeeping into accounting."

Auditing is one of the elements which distinguish accounting from bookkeeping, and the development of auditing is an interesting story in itself. In the fourteenth, fifteenth and sixteenth centuries auditors were required in Great Britain to "hear" (for few could read) the accounts of various officers charged with fiscal responsibility. By 1800 the scope of the auditor's work had expanded and increasing emphasis was laid upon visual scrutiny of written records and examination of evidence in support of entries. A series of commercial crises and passage of legislative enactments by the British parliament in the first seventy years of the nineteenth century led to the development of a body of independent practitioners offering skilled services to the public. Accounting practice in that period was usually associated with law practice, but by the last quarter of the nineteenth century auditing procedure had become fairly well differentiated and organized.

Throughout their development bookkeeping and accounting have justified their existence by keeping pace with the increasing demands of the commercial world. They appeared in response to a definite need and each forward step has been directly related to some change in business or economic life.

Professor Littleton traces the evolution of ledger entries from an early form in which the complete transaction was expressed in full detail, to the modern highly-abbreviated tabulations of the values involved. Full statements of transactions were at one time entered directly in the ledger accounts involved. Later preparation of a highly technical form of journal entry preceded the record in the ledger, and then, for a long period, the journal entry expressed more or less fully a complete thought. In the present day the journal entry, quite technical in form again, is designed for accurate sorting

of accounting units, and is dispensed with entirely for many transactions recorded in numerous books of original entry. The modern bookkeeper—the one who is responsible for uniting into a coherent whole the maze of detail included in the complex records of today—"has a task the like of which none of his predecessors ever faced, and the very act of bookkeeping is harder than ever before. Bookkeeping has become a real technology instead of a simple clerical routine."

This volume gives evidence of a vast amount of research and contains numerous references for those who wish to pursue the subject further. Most of Paciolo's text is presented, and there are many examples to illustrate changing types of ledger entries, journal entries, financial statements, etc. It should fill a definite want for all who are interested in the history and development of accounting.

R. A. Bryant

Arthur Andersen & Co.

The Nature of Dividends. Gabriel A. D. Preinreich. (New York: Lancaster Press, Inc., 1935. Pp. vii, 226. $2.50.)

To the careful reader, Dr. Preinreich's book represents at once a revelation and a challenge. The entire subject is passed here in review, disregarding largely existing financial, legal, economic, and accounting theories, and considering it afresh from a strictly theoretical point of view. This secures a measure of objectivity that could not otherwise be attained. To be sure the major emphasis is placed on the development of a mathematical theory of corporate distributions whether in the form of cash, property, stock dividends, or evidences of indebtedness, the legal and economic phases being rather abridged if not submerged outright.

A clearer conception of the author's treatment may be obtained by examining the premises upon which he bases his discussion. These are:

(1) A complete disregard of the corporate entity, putting the stockholder on the same plane as a partner in a firm.
(2) A similar disregard of the well-known principle of valuation of cost or market value whichever is lower, and an insistence on a strict market valuation theory.
(3) A definition of income which includes not merely the normal stream of services flowing from a capital good, but also covers added value due to its appreciation and the goodwill adhering to it.

Granted these premises, the book develops its thesis logically enough. "The investor, paying a price in excess of book value for the stock purchased, has . . . thereby divided his investment into a portion measured by the corporate books and a portion not so measured." (p. 5). Since the stockholder thus invests in reality in market equities, the law governing market values of common stocks is then formulated and expressed as a function of four variables; viz.

"1. The *earning rate* or the quotient of earnings by that portion of the corporate net worth which represents productive assets. This excludes idle assets which may have been hoarded.
"2. The *expansion rate* or the rate of increase of the *productive corporate net worth* owned by the investor.
"3. The *money rate*, at which the future services of capital are discounted.
"4. The *horizon*, or number of years beyond which the investor is unable or unwilling to look into the future" (p. 10).

The examples furnished to illustrate mathematically the principles involved are somewhat sketchy; the average reader must spend considerable time arriving at the indicated results.

Turning his attention from the nature of capital to the nature of income, the author here attempts to show that there are many concepts of income, citing for the purpose the well known concepts of Eisner v. Macomber, Irving Fisher, the Federal Income Tax Regulations, etc. Incidentally, it seems to the present reviewer that accountants might profitably give more attention to Professor Fisher's theories of capital and income, since he certainly approaches more closely the accountants' notion of these topics than any other economist.

The author summarizes the various meanings of income as follows:

"1. The entire difference between two succeeding capital levels representing the investor's wealth at two stated dates. (In this sense, income includes the so-called "unrealized capital increments," viz. increments which have not been realized by a closed transaction.)
"2. The difference between two succeeding levels of the company's net worth owned by the investor, as determined by standard accounting procedure which is unable to measure unrealized capital increments.
"3. The fair market value of all distributions received, irrespective of changes in the capital level.
"4. The book value or fair market value of distributions received, less adjustment of cost for certain forms of equity dilution.
"5. The receipt of cash" (p. 24).

He then formulates his own definition of income as the "realization of wealth which did not exist at the time the investment was acquired, but arose subsequent to that date," (p. 44). In other words, he agrees substantially with method (1) cited above.

The results obtained by applying the various income theories are startling. Thus under the cash and "income received" methods, the stockholder takes up in his records merely the amounts received in the form of dividends. Under the accrual method, he takes up on his books his pro rata share of the entire corporate earning by debiting the investment account and crediting income! When the dividend is collected, it is credited to the investment account, and thus under this theory, all dividends become distributions of capital (book value). Finally, under the market value theory, the investor takes up not only the pro rata share of earnings, but also the unrecorded market equities (appreciation) which represent so much paper profits (p. 50).

In considerable detail, the author then applies these theories to the valuation of stock dividends, stock rights and warrants, deriving in each instance the mathematical technique for their evaluation, in an attempt to protect the investor's capital, and furnish him with a guide enabling him to determine the extent of his income. Briefly, "earnings distributed equal that fraction value of the entire book of a distribution which will not reduce the book value of the old stock certificate below what it was at date of acquisition" (p. 166).

The chapter on regulation v. education discloses the author's attempt to make his theory workable within the framework of our existing institutions. The passage of a law, however, is necessary which provides among other things that "before the first day of the third (?) month following the close of the company's accounting period the number of shares formerly outstanding shall be increased or reduced in such a manner that the product of par value and the number of shares shall neither be more than 101% (?) nor less than 99% (?) of the respective equities appertaining to each class of stock, as disclosed by the audit" (p. 168).

Objections on grounds of administrative difficulties are answered as follows: "Individual stock-ledger accounts are already kept by every corporation; all that would be necessary is to place them on the basis of cheque accounts and send replicas of bank statements to each stockholder, containing a full list of all stock debits and credits during the period. Transfers could just as well be effected by stock cheques deposited for collection in the usual way" (p. 169).

Thus a corporation would be forced to distribute earnings in excess of expansion in cash, and the reinvested earnings (commonly referred to as undistributed surplus) in the form of stock. By thus keeping the stock oscillating around par, there will always be a constant volume of assets representing a share of stock.

What the effect of this scheme would be on our existing financial-economic mechanism is problematical, as is also the possibility of a satisfactory solution of the income-tax problem. Thanks are, however, due the author for presenting us with a unified theory of income.

THEODORE LANG

New York University

A compact and meaty book, very suitable for one whose briefcase is already well filled; an excellent summary chapter for the man who wants the essence without reading two hundred pages; many intriguing diagrams if your mind works better with graphic comparisons than with figures alone; a mathematical appendix for anyone whose college calculus really "took"; a bibliography in case it should occur to the reader to turn up the literature of stock dividends: something for everyone as it were.

Yet the reader who hopes for a general discussion of dividends will be disappointed at the successive limitations by which the author restricts the scope of his investigation. First, the legal and accounting conditions precedent to the declaration of dividends are excluded so that dividends may be considered only from the point of view of the investor. Then preferred stock is excluded so that "investors" will be only those who hold common stock. Finally common stock investors are subdivided in order to locate the area in which "further development in the theory of measuring income is necessary to progress. . . ." This is found in that group of investors who make investment a profession—investment trusts. Their records "should embody the utmost refinements to disclose changes in the wealth invested as accurately and as promptly as possible" (p 28).

The kernel of the dissertation, therefore, appears to be the common stock problems of investment trusts and the inequities which the usual rules regarding the determination of income may produce when applied to stock dividends, stock rights, and stock warrants.

The discussion of these problems occupies nine chapters. After two introductory chapters on capital and income, there are five chapters on the various kinds of dividends. Chapter VIII is, in effect, a summary of the argument and a statement of the author's conclusions. The last chapter deals with distributions in fiduciary accounting.

The chief source of the problem here discussed apparently is a certain dissatisfaction with the theories implied in the stock exchange and income tax regulations regarding the treatment of stock dividends, stock rights, etc., as income. The author's contention is that it is unsound to consider either the distributions themselves or the receipt of the proceeds from their subsequent sale as the clue to realized income. For example, to do so is to receive unawares a return of part of the original investment if the dividend declaration should be made from corporate surplus accumulated prior to the date the investor acquired the stock. (This seems to be a generalization for the individual investor based upon the familiar problem raised in certain consolidated balance sheet situations, but the author makes no use of the analogy). The issue then is drawn: Is investor-income related to the dividends declared and the distributions made, or to a gradual increase in book value of the securities as the corporation's net worth grows from earnings?

That there is an important question here can hardly be denied. Corporate officers and their advisers have been so ingenious of late in producing new types of security contracts and distributions to whet security buyers' appetite and draw out the last available dollar, that more than a suspicion is aroused that within these intricate complications of finance there lurk many possibilities for the dilution of equities and the generation of ungrounded hopes, among other socially undesirable, and perhaps unintended, results.

The natural reaction to complications is a swing back toward fundamental simplicities. Therefore, the author prefers to ignore the intervening corporate entity, and to see the investor's income first appear in measurable form as the earnings of the corporation. This view has the advantage of bringing forward the principle that no distributions, whatever their form, alter in the least what the investor already had—an increase in the book value of his stock. In order to reinforce the intimate relation between investment in

stock and book value of stock, he proposes to bring the original idea of par stock into its real destiny.

In the original joint stock companies the expectation was that the entire profit would be distributed at frequent intervals, and the stock would continue for a short term of action to represent the original investment. When that ideal fell into disuse through the development of corporate permanence, book value and par value fell apart. To secure book reversion to the original idea it is suggested that the use of properly proportioned stock dividends for profits and stock cancellations for losses would keep constant the relation of par value and book value per share.

In order to bring about the conditions which would practically merge the financial identity of the corporation and the investor, and bring about this change in net worth accounting, it would be necessary to require, (1) that expansion to be expressed always in stock, (2) that expansions in excess of earnings be expressed in subscription rights, and (3) that cash or property dividends be restricted to earnings in excess of expansion.

"Require" is a strong word and would necessitate a new type of statute law. The avowed weakness of the study lies just here, for the author recognizes that the inertia of long established custom places immense practical difficulties in the path of any such thoroughgoing changes. Yet he feels, with a good deal of justice, that a close analysis of dividend distributions would bring a clearer view of the realities of income determination.

If any criticism were to be offered to the author's analysis, it probably would relate to his too ready acceptance of the idea that "looking through the corporate fiction" is necessary, and his willingness to identify the corporate assets, invested or earned, with the common stockholder.

The corporation is an important institution of modern society, created, it is true, by law, and having no personality separate from those who supply its capital or carry out its avowed purposes. But it is hardly a fiction. Just as a family is more than the sum of its several members, and a home is more than a house, so a corporation is more than a mere aggregate of associated members. It is because it is something more that we may say with truth that the corporation is an *entity*. If the corporation is an entity, then neither it nor its assets can be completely identified with either a part (common stockholders) or the whole (all security holders) of its constituent membership. The corporation is more than an expanded proprietorship owing debts to its bondholders, as is implied in the author's argument. It would be sounder to see in the corporation a social instrument which serves all who supply it with capital, labor, or sales.

It is more important that good accounting and sound finance be pushed into all corporate operations, than to devise ways and means for investors to untangle the significance of corporate practices of doubtful soundness. It is a mistake to create, however innocently, the impression that the correct measurement of investor income (a sort of interest-return at best) is a more basic problem than the correct measurement of corporate income (the resultant of an interplay of cause and effect, expense and revenue).

This seeming exaltation of investor income, however, is mainly an incidental result of setting very close limits to a specified piece of research. With a broader canvas the larger picture would emerge—the picture of income in general.

In any event here is an excellent example of the alliance between accounting and finance. The trained accountant (the author is a C.P.A.) can bring much to corporate finance, and corporate finance can contribute a great deal to training the accountant.

One cannot but wish that the present monograph were a treatise. Perhaps it is not too much to hope that this excursion into a section of income theory may be followed up by the author with the rest of the story. An equally penetrating analysis of the legal and accounting basis for dividend declarations would be just as interesting to conscientious corporate directors as the present work will be to the managers of investment-trusts and advanced students of investments and finance. The scope of the study is too restricted, the subject too technical, and the treatment too theoretical, to make the book very serviceable to casual investors or undergraduates.

A. C. Littleton

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Analysis of Industrial Securities. John H. Prime, (New York: Prentice-Hall, Inc., 1935.)

With the popularity of railroad and utility securities at least temporarily in eclipse and "industrials" in extremely high favor, this book is most timely. It is written in a clear, straightforward style and illustrated to an unusual extent with the financial practices of the better known industrial corporations so that it is likely to please both the student and the practical investor.

The first third of the book is devoted to general considerations. An introduction recounts the aspects of New Deal legislation affecting industrial earnings. The effect of the depression upon income through the year 1933 follows so as to provide a tangible background for the discussion of the business risk factor. A chapter upon industrial research indicates something of the possibilities of improving production methods, promoting economies in marketing, and discovering new products that may place the corporation in an advantageous position. From this general setting, the treatment goes on to the peculiarities of the different industries,—using as illustrations automobiles, petroleum, copper, rubber, and bituminous coal,—and then the situation of the individual corporation within the industry with respect to management, integration, and diversity of products and markets.

The remaining two-thirds of the book is devoted to the description of financial statements and methods of utilizing them. Chapters are given to the general subjects of the income account and the balance sheet, and the special topics of depreciation and depletion, and capitalization. The book closes by showing how this financial material is focussed on each of the three classes

of securities, bonds, preferred stock, and common stock, and by illustrating procedure with a brief study of Goodyear Tire & Rubber Company and a comparison of American Can and Continental Can.

In statements of fact an occasional slip will be noted by the careful reader. In describing the usual capitalization of the various industrial groups, it is stated (p. 242) that the speculative character of the extractive industries—such as oil and mining—results in their using stocks. Actually, the larger oil companies are among the more frequent users of bonds. Of the eleven major companies significant enough to appear in Moody's list for which financial ratios are computed, all but one showed funded debt at the end of 1934. Again, it is stated (p. 303) that relatively few of our strongest industrial corporations use bonds but many have preferred stock issues. Figures for combined capital structures indicate that bonds are as large as if not larger in total than preferred stocks for industrials generally and large corporations especially. Unfortunately, business practice does not always follow the course that conservatism would seem to dictate.

Accountants will differ with Dr. Prime in his use of depreciation to include declines in market value of all kinds of property, such as securities and inventory (pp. 151, 330). His definition of depreciation (p. 150) as "the difference between original cost and present market or liquidating value of an asset" is not in accord with accounting usage and might mislead the ordinary reader in his interpretation of the conventional income account. Similarly, criticism may be levied against his classifying the contingency reserve apart from the net worth accounts (p. 229), although the common failure of published balance sheets to specify the basis for such reserves makes it generally necessary for the financial analyst to exclude this vaguely titled item from the true "surplus" reserves in arriving at such a figure as the "book value of the common stock."

The absence of the more detailed subtleties of security analysis, such as ratio study, intercompany comparisons, graphic presentations and study of market action, while likely to make the work of less interest to the person of more advanced knowledge, has nevertheless contributed to the clarity of presentation which is likely to make it popular with the general investor desirous of evaluating the material upon those major points that are customarily stressed in investment services, brokers' letters and the press. Furthermore, the younger members of the accounting profession will find the wealth of illustration a stimulating point of contact between their general knowledge and the affairs of our leading industrial corporations.

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Cost Accounting, Principles and Practice. James L. Dohr, Howell A. Inghram, and Andrew L. Love. (New York: The Ronald Press Company, 1935, Pp. xvi, 620. $4.00.)

This is a second revised edition of Professor Dohr's *Cost Accounting, Theory and Practice,* the first edition of which was published in 1924. The new edition is practical both in principal and practice. Changes have made it a richer book but the general approach remains the same.

The book is divided into four parts as follows:

Part I—Introduction to Cost Accounting
Part II—Cost Accounting in the Manufacturing Enterprise
Part III—Special Cost Problems in the Manufacturing Enterprise
Part IV—Cost Accounting Systems

The first objective of Parts I and II is to tell the student what cost accounting is and why it is needed; the aims and purposes of cost accounting; and its relationships to general accounting and to other functions of the business organization. The presentation is excellent and considerable space is devoted to these matters in order that the student may have them well in mind before taking up the detail of cost accounting procedure.

Emphasis is placed on the fact that cost accounting is not an end in itself but a means to an end. As stated on page 4, "Only in so far as it is useful in the administration of the enterprise is cost accounting worth while. The most important aspect of any system of cost accounting procedure is the intelligent use of the information obtained by the administrators of the enterprise." In line with this the goal of accounting is later (page 71) stated to be, ". . . the development of a complete set of timely and accurate costs reports." In many companies accountants have risen to positions where they not only supervise the preparation of these reports but interpret them and go far in seeing that proper action is taken on the basis of their interpretation.

Part II is continued with a study of cost accounting largely from ". . . the 'historical' viewpoint, i.e., as a method of making an accurate and organized record of business events (which record, of course, is predicated upon the accepted double entry rules of bookkeeping)." In the chapters devoted to this the basic cost procedure is developed. Having set costs reports as the goal of the cost accountant, and having described these reports, the book proceeds with a study of the ledger which forms the direct source of the information included in the cost statements and reports. This study includes the use of cost controls and subsidiary ledgers, and the collection of costs in the ledgers under process costing and job order costing. Of particular importance is the material on control accounts which, it appears, is superior to that to be found in any other cost accounting text.

In connection with the treatment of ledgers the book describes the use of cost sheets. Then it goes on to a consideration of the journal, including special journals, and to a study of original evidences of transactions for material, labor, production, shipment, and distribution.

Part III covers special cost problems including the acquisition and use of plant, machinery, and other assets. Chapters are included on manufacturing risks and the costing of by-products and joint products. In this section also cost accounting is approached from the viewpoints of control and measurement of efficiency.

The use of budgets and standard costs is presented clearly and effectively.

Part IV considers various types of cost accounting systems, their design and installation.

Throughout the book careful attention has been paid to terminology. A glossary has been included. References at the close of each chapter refer for the most part to articles appearing in the publications of the National Association of Cost Accountants.

The book is well written throughout and a wealth of material is presented in a concise and readable manner. Many teachers should find it worthy of adoption. It is a valuable addition to the library of the teacher of accounting, the practicing accountant, and the business man.

C. B. Nickerson

Harvard Graduate School of Business Administration

Encyclopedia of Banking and Finance. Volume I. Glenn G. Munn. (Cambridge: Bankers Publishing Company, 1935, Pp. viii, 784. $6.50.)

Whereas the third edition, revised, 1931, of this work comprised 765 pages, the fourth edition is to be in two volumes of which Volume I, 784 pages, is now ready. Volume II is to be ready during the winter of 1935–36. More or less permanent subjects, including bibliographies, have been put into the first volume, and law and tables subject inherently to modification have been assigned to the second volume. This arrangement makes it possible to revise the second book whenever needed without necessarily requiring a revision of the first book.

The whole work is a reference manual with over 3,500 terms relating to money; credit; banking practice; history; law; accounting; organization and Government supervision; trusts; corporate and Government finance; foreign exchange; investments; securities; speculation; business organization; insurance; commodities; markets; brokerage; and business economics. The material in the first volume has been substantially recast and reconstructed and the second volume contains the text of all Acts pertaining to money and banking passed since March 4, 1933 as well as the most important laws in this field since 1913. In general every title in Volume II appears also in Volume I, references in the latter calling attention to the former. Both volumes are arranged alphabetically.

This work should prove indispensable in schools of commerce and in the libraries of public accountants.

Arthur W. Hanson

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Walton Federal Income Tax Accounting and Procedure, 1935. Charles H. Langer and Harry A. Knautz. (Chicago: Walton Publishing Company, 1935.)

This loose-leaf text begins with a reprint of the Revenue Act of 1934 and the Revenue Act of 1935. It is stated in the preface that the course was prepared (1) "to present in logical sequence a thorough discussion of the fundamental principles of Federal income taxation in language easily understood . . . "; (2) in a teachable manner, (3) sufficiently exhaustive to enable practitioners to use it as a guide in the preparation of returns and in the handling of tax cases. An introduction explains terms; how to use the law regulations, and bulletins; the "ability to pay" principle of taxation; and the history of income taxation in the United States.

The course material proper is prepared in twenty-four lectures which include discussion, references and examples. Each lecture is followed by several tax problems and tax questions, solutions to which are also available.

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Retail Accounting. Cecil K. Lyans and Norris A. Brisco. (New York: Prentice-Hall, Inc. 1934. Pp. xxii, 590. $5.00.)

Retail Merchandise Control. John W. Wingate. (New York: Prentice-Hall, Inc. 1933. Pp. xv, 478. $5.00.)

For some time workers in the field of retailing have been coming to realize more and more keenly their need for reliable printed materials on the accounting and merchandise control aspects of department store management. These two books by members of the faculty of the School of Retailing, New York University, fill this need admirably, and they properly may be listed among the outstanding contributions to the literature of retailing in recent years.

The authors of both books clearly were competent; and in both instances competency was based upon practical experience in stores as well as upon careful academic study. The books cover their respective subjects thoroughly and in painstaking fashion. Without being heavy or boresome, they go into sufficient detail to serve as textbooks for teachers of college courses, as assigned or collateral reading for those courses, and as books of reference for students, practicing accountants, or store executives. Both books are logically organized and well written; and both are amply equipped with illustrative and explanatory matter. Lyans and Brisco, for instance, include 87 *figures*, almost all of which depict accounting or statistical forms; and where alternative systems or methods are in wide use, they describe all the systems and give clear-cut expressions of opinion as to which is to be preferred. Notable in this connection are the discussions of the unit and dual systems of handling accounts receivable, the handling of cash and of sales checks, and the use of tabulating machines in the accounting office. Helpful treatment of these and other operating questions, however, does not interfere with clear presentation of topics which may be referred to as *strictly accounting*, i.e., those relating to the journal, the general ledger, the balance sheet, and the operating statement. Wingate did not find it necessary to introduce so many forms, although the number used is adequate; but he adopted the commendable practice of using sample figures to make clear the various principles, problems, and arithmetic relationships described. These sample figures constitute a most helpful feature of the book. From the standpoint of the teacher, it is

helpful also to have the specific references, which are given at the end of each chapter, to teaching materials in problem or case form published elsewhere, and the ample bibliographies.

One frequently hears it said that elementary courses in accounting pay too little attention to the special problems of trading enterprises in general and of retailers in particular; special problems which include those of handling multitudes of small transactions, both for cash and on account; those connected with C.O.D. and installment selling; those connected with inventory valuation where depreciation or obsolescence often operates with startling promptness and speed; and even some connected with the arrangement of the operating (or income) statement itself. If true, this is unfortunate, especially for the students in those courses who later study retail store management, go into retailing, or enter public accounting offices.

Teachers of accounting who feel the need for additional retail background, or who wish to investigate retail store problems with a view to deciding whether these problems should receive more emphasis in their courses, will find Lyans and Brisco a helpful and reliable document. Its purchase should be recommended, also, to all students preparing themselves for public accounting work and to all graduates now practicing that profession. Graduates filling accounting positions in retail trade, whether among department stores or other types of distributor, surely will find the book stimulating and valuable. Finally, any reader who needs a well-rounded knowledge of accounting in all its applications should not overlook this book which may well become indispensable in its field.

Wingate's *Retail Merchandise Control*, also, is quite likely to become a fixture in its field, but from the accountant's standpoint, the field is somewhat more specialized. Surely, however, the book should form part of the library of any accountant dealing in a broad way with department store, or retail, budgets and systems. Wingate properly thinks of merchandise control as embracing not merely unit control or price records, but as including also all the machinery available for use in the attempt to keep inventories in the correct relationship to sales. He deals at length, therefore, with the merchandise budget, sales planning, the retail method of inventory, stock-turn and the stock-sales ratio, with departmentization, and with numerous technical details regarding which clear explanations often are especially desirable. In addition, he gives a thoroughly practical discussion of unit control methods.

Although both these books use in their titles the word *retailing* which implies treatment of all, or many types of retail distributor, both deal almost exclusively with department store problems and practices. The principles and methods described *may*, and in many instances do, apply to other types of retailer as well, especially to unit stores dealing in lines of merchandise similar to those carried in department stores; but the books do not deal specifically with the problems or practices of the important types of retailer other than department stores, and neither do they describe the methods of adapting department store experience to these other kinds of business. The fact that both books meet admirably very real needs for information with reference to department stores is not at all inconsistent with the fact that accountants and retailers alike still are awaiting books on accounting, on merchandise control, and on other aspects of store management dealing with the field of retailing as a whole, and making significant comparisons between the problems and methods of different types of retailer. For instance, workers in this field still lack adequate literature on grocery chains, variety chains, mail order houses, gasoline filling stations, and automobile retailers, to mention five important groups.

Carl N. Schmalz

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November, 1935.

Income and Economic Progress. Harold G. Moulton. (Washington D. C.: The Brookings Institution, 1935. Pp. xi, 191. $2.00.)

This is the fourth and last volume of the series which includes *America's Capacity to Produce*, *America's Capacity to Consume* and *The Formation of Capital.*

The first section of "Income and Economic Progress" is devoted to a rapid but excellent summary of the three preceding volumes. Some basic questions are restated, such as "have we lived beyond our economic means?" "are we suffering from general over-production?" "can curtailment of production solve our difficulties?" and others pertaining to what has been called our "economic old age," and to the equalization of wealth. These questions are not raised here for discussion. The data included are, for the most part, taken from the preceding volumes. These questions are restated in order to add point to the real inquiry in this fourth volume which is in the field of income distribution.

Previous studies of the Brookings Institution have shown that we are not suffering from general overproduction. However, we do have excess capacity relative to existing demand. The problem, then, is to get this excess productive capacity into use and to create a demand for the additional products which would be produced.

The first method of creating sufficient effective demand to absorb the output of our productive system, when operating at capacity, is that of taxation. The results of taxation systems are not minimized. ". . . there are significant long-run possibilities of using the taxation machinery as a means of expanding the volume of free services furnished to the public as a whole." Thus the taxation machinery is viewed as useful for the provision of such public facilities as parks and playgrounds but it is regarded as of little importance when the problem of effecting a better distribution of purchasing power is considered. In fairness to the writer, it should be noted that the forms of taxation and the effects of various taxes on income distribution and on the purchasing power of particular groups have not been studied. While the inclusion of such a detailed study might throw light on the results of certain taxes it would not invalidate the general conclusions advanced.

The second method studied which has as its aim the raising of purchasing power of consumers is the raising of money incomes. This method has been on trial in recent years and has been advocated by various labor organizations. This method is analyzed in two parts. First, as a means of stimulating recovery during depression periods, and, second, as a means of "promoting continuous or long-run progress." The first analysis runs in terms of experience under the N. R. A. Codes. The theory assumes that by raising wages purchasing power would be expanded. This increase in purchasing would "call forth a larger volume of production which would automatically absorb unemployment." This result was not attained under the Codes because the increase in wages was quickly reflected in increased prices which counteracted the increase in wages. "While price increases might theoretically have been retarded without reducing eventual profits, the fact remains that without an effective means of controlling prices this plan could not be expected to work. Increased wages enter directly into the cost accounts of business corporations. Since the plan was inposed at a time when a majority of business corporations were already confronted with deficits, it was practically inevitable that prices would be raised as a means of recouping the added outlays."

The second analysis, relating to the use of increasing money wages as a means of increasing effective purchasing power, from a long-run standpoint, is in terms of more nearly uniform periods than that of 1933–34. Some gains, in each case referring to wage rates rather than to wage disbursements, are noted, for example an increase in hourly earnings during the period of 1922–29, which exceeded the increase during the same period in cost of living. The conclusion is that, while at times money earnings of employees (in the manufacturing industry) have increased faster than commodity prices, nevertheless this method cannot be relied upon to secure an increasing real income for our working population. This method runs against the resistance of our economic system. Wage advances are usually granted under pressure. Wages enter into costs of production and " . . . there is a strong tendency for such increases to be accompanied by advancing prices."

The method which meets with the approval of the author for increasing the real income of the bulk of our wage earning class is that of reducing prices. This method is regarded as extending the benefits of lowered prices to every purchaser whereas other methods aid only special classes. Further, this method of increasing real income would aid the farming class and would strengthen the nation's position in the export market. The conclusion is drawn that "The broad highway along which continued economic progress must be sought is the avenue of price reductions. When this road is followed the benefits of technical improvements are conferred automatically upon all divisions of the population. Maximum opportunity for expansion of production and the free interchange of goods both between different divisions of our domestic economy and between nations is thus provided. Such a method instead of centering upon a redistribution of an existing amount of income promotes the progressive erection of additional income and its prompt and thorough dissemination among the entire population."

It has been stated above that the most desirable means of raising the real income for the bulk of our people is that of price reductions. Such reductions should be made as technical efficiency increases. However, the author finds that, while in the period of 1922–29 the efficiency, as measured by gainfully employed persons, increased 18 per cent and the productivity per wage earner in manufacturing industries increased 25 per cent, prices remained relatively stationary. In fact retail prices increased slightly during this period. The factors responsible for this price stabilization are to be found chiefly among the forms of business organization. In particular industrial combinations, cartels, and trade associations have operated in such ways as to maintain prices (from the short-run point of view) and stabilize operating conditions.

The question of industrial profits is, of course, closely tied up with wages rates and selling prices. Profits during the prosperous years of 1922–29 were sufficiently large to allow businesses to pay out increasing amounts in the form of cash dividends and still set aside large amounts of surplus. These results occurred during a period of increasing efficiency and stable selling prices. The point of the writer is that the volume of business could have been increased during this period by reducing prices as efficiency increased. Whether the wider markets which would have resulted would have been sufficient to allow the same profits as were made through higher prices and smaller volume cannot be statistically determined. The author states that " . . . profits might well have been larger . . . " and "Even if profits should not actually increase, a contribution is nevertheless being made through the expansion of wealth production toward raising the level of material well-being—which is the ultimate purpose of an economic system."

The basic economic policy set forth in this volume is that, because of abuses of our economic system, centralized control has been set up which operates to protect the existing price structure. This tendency is held to be short-sighted and leads to "freezing" situations " . . . which in the interest of economic progress must be left as fluid as it is possible to make them."

The conclusions in this volume are not novel, but they are based on logical premises, are well-supported by statistical material, and are admirably stated. These conclusions are particularly interesting today in view of the variety of panaceas offered as cures for our economic ailments. *Income and Economic Progress,* gets away from quick-cure schemes and back to fundamental principles.

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The Economics of Inflation. H. Parker Willis and John M. Chapman. (New York: Columbia University Press, 1935. Pp. xi, 443, $4.50.)

The authors explain, in the preface to this volume, that Part I (twelve chapters) has been prepared by

themselves, the instructors in the Banking Seminar at Columbia University, while Part II " . . . is the contribution of various members of the Seminar . . . " And its eleven papers are " . . . believed to have an important bearing on some phase of the inflation problem . . . ."

Dr. Willis analyzes the prevailing popular conceptions of inflation and the respects in which they agree and differ, but he finds very little to assist him in formulating a definition. However, he does find that " . . . one of the major issues in connection with inflation is unquestionably whether it is or is not sound and right ever consciously to use the banking and currency system of a nation as a means of bringing about a redistribution of wealth." Moreover, he is careful to make it clear that inflation does not necessarily taken the form of price (p. 26) and even if it does, " . . . bank credit is a subsequent and not a preliminary development in connection with a price movement . . . " in a boom. Monetary inflation is then distinguished from banking inflation, the former being " . . . a change in the basic unit of value with a corresponding change in all obligations that were expressed in terms of such units, or a change in the attainability of the posssession of the unit." On the other hand, banking inflation involves a clearly erroneous appraisal of values.

As for inflation in a non-monetary sense, Dr. Willis takes the view that "No satisfactory conclusions about inflation can be reached except on the basis of definite price theory . . . ." This approach leads him to develop the thought that banks may fail to function wisely in deciding whether " . . . funds should be supplied to a given industrialist or not . . . ." But, what is much more important, industrialists are often practically independent of banks (p. 65) and in that event, errors in recognition of credit cannot be traced to the banker. Consequently, dislocations of industry and overproduction cannot always be traced to errors of judgment on the part of bankers. The problem is, however, larger than one of credit extension, whether wise or unwise, since dislocations sometimes arise from (a) the development of new industries, (b) the intervention of some new process of production or (c) from social disturbances. Thus, he arrives at the conclusion that, "Inflation . . . appears as a process of unduly raising the volume of given classes of goods, or of machinery for producing such goods, to a point where it is out of harmony with the capital or goods situation in other branches of industry." The position of Dr. Willis with respect to inflation is undoubtedly the most tenable of the several views that may be and are taken by economists today.

In taking up "Inflation as a Contemporary Problem" Dr. Willis makes a number of observations which should not be passed over. Thus, our participation in the World War was financed by inflationary devices which in turn brought on the panic of 1920–21 and the latter was " . . . nipped in the bud through well-considered action on the part of the banking authorities." As for the present situation, "The violence of the struggle that has been waged during the past three years . . . seems to show that very strong elements . . . are unwilling to submit to the periodical readjustment which for many years has followed the undertaking of overdeveloped and profitless schemes . . . ." Finally, there has never been an instance of currency management designed to assist the creditor class. Rather, it has always been proposed as a means of relief for the debtor class.

Reverting once more to the nature of inflation, he observes (p. 136) that while " . . . a change in the actual volume of money or purchasing power has its weight in the establishment of a level of prices, there may be at any given time many factors of vastly greater weight . . . " and this has been the case during the past decade. But this thought should be considered along with the statement that "The problem of prices and price control is not fundamentally a problem of the control of the general level of prices, but is a problem of proper adjustment or relationship of the different groups of prices." Finally, Dr. Willis takes up the recent concept, "business inflation," a more refined form of inflation theory than those generally held, and holds that, while "Credit so advanced or 'released' is, however, believed to 'flow' without hindrance out of the speculative market and into business . . . ," there is not " . . . a scintilla of evidence afforded," that this is true. (p. 146) In passing to Dr. Chapman's contribution, it should be said that Dr. Willis has presented an able treatment weakened, however, by his failure to go into the rigidity of prices.

Dr. Chapman takes up *Speculation and Prosperity* in the course of which he presents the more obvious facts and then passes to *The Business Man and Inflation*, where it is said that the business man " . . . is usually a victim, regardless of whether he is favorably or unfavorably disposed toward inflation." In the discussion of *Inflation and Investment* he explains that forced saving results in one type of inflation and he attributes the dislocations of 1920–29 in part to this practice plus speculation. Dr. Willis then concludes Part I with a chapter of conclusions, in which appears a final view of inflation as occurring " . . . when artificial alteration is brought about in the incomes of the several members of the community, or when they are induced to apply these incomes in a fashion radically different from that in which they were previously employed."

Part II, "Supplementary Essays," contains a number of excellent papers but reference can be made to only a few. Mr. Anatole Murad's useful discussion of *Inflation in Current Economic Literature* concludes with the statement that " . . . inflation is generally considered to be: essentially, a disturbance of prices due to monetary forces," and the author seems to think this conception quite debatable. Mr. M. A. Heilperin, in discussing "Inflation and Overproduction," holds that " . . . reflation is not primarily a monetary policy. It is an economic policy . . . ." Mr. A. Wilfred May contributes an excellent paper on "Inflation in Security Prices" in which, among others, he brings out the point that "The existence of any central banking system or any other form of credit management in America is always a potential source of nationwide speculation . . . ." In "Inflation and the Structure of Production" Mr. F. F. Schumacher considers " . . . monetary disequilibrium—forced saving—the main cause of the

business cycle." In "Price Reflation," Mr. Erik T. H. Kjellstrom points out that "Although cost factors may be more slow-moving than commodity prices . . . " they are perhaps, " . . . the most fundamental difficulty encountered by a program of reflating prices to a predetermined level. . . . " Moreover, from his analysis, " . . . it would seem very difficult to bring about a rise in prices to a predetermined level by purely monetary means. Truly, there is much in this volume in conflict with the views of Warren and Pearson.[1]

In appraising this volume the reviewer is impressed with the able effort of Dr. Willis to work out a conception of inflation that is broader and more substantial than that which rests on the purely monetary approach and he is also impressed with the high quality of the results obtained in the seminar on banking. Finally, it should be said that the volume will most assuredly fill an "aching void" in that it provides an effective treatment of a subject on which the literature has been either fragmentary or unassembled in a form suitable for college use.

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The International Money Markets. John T. Madden and Marcus Nadler. (New York: Prentice Hall, Inc. 1935. Pp. xiii, 548, $5.00.)

The authors announce that the purpose of this volume is the analysis " . . . of the changes in the rôle of gold and the causes of its collapse in the post-war years; to study the functions and operations of the international money and capital markets; and, above all, to describe the organization and operation of the leading international financial centers." In carrying out this task they have devoted five chapters to the money market, to the capital market and to the restoration and collapse of international money markets. Three chapters each are given to the New York and London money markets, two each to Paris, Berlin and Amsterdam and one to the Swiss money market. There is also a selected list of references arranged by chapters.

The discussion opens with "Gold and the rôle of the Gold Standard," in the course of which it is pointed out that the erroneous belief in a shortage of gold was partly due to the fact that " . . . the liabilities of central banks (were) expressed in depreciated currencies and the gold reserves at the pre-war parity." Here also it is said that the legal requirements of a certain minimum gold reserve against notes in circulation and against demand deposits of central banks have under modern conditions " . . . considerably outlived their purpose." Evidently the authors would not contend that some gold reserve is not essential, considering the fact that Federal reserve notes would otherwise rest entirely upon value in the process of emergence or a lien thereon, in the case of United States obligations. They also recognize the difficulty of reconciling " . . . the internal money market situation of an individual country with that of the international money market," but they trace the problem, in the United States, to the overshadowing influence of domestic business conditions. One might well ask for an explanation of the same problem in England.

The function of the money market " . . . is to finance short-term transactions . . . ," while that of the capital market is the financing of long-term transactions. The restoration of the money markets after the war was defective for a number of clearly stated reasons and collapse was inevitable. Restriction upon the international flow of capital and credit and the fluctuating currencies now stand in the way of another restoration. The authors do not attribute recovery in Sweden to operation of a managed currency, since the kroner " . . . moved in unison with the pound sterling . . . ." The clearness with which these and other general principles are brought out in the first five chapters is most commendable, in spite of a tendency to oversimplification. However, that fault may be attributed to the necessity of providing a general introduction without permitting it to absorb too much of the volume.

Of the institutions related to the New York money market the Federal Reserve bank receives the major consideration and it is pointed out that for the present that institution is less a factor in the money market than is the Federal Treasury. (p. 148) The consideration of the position of the commercial banking system in the money market does not make allowance for the correspondent banking system and its serious deficiencies in a crisis. Neither is the influence of the latter upon the money market sufficiently taken into account. The several component markets within the New York money market are briefly analyzed and then the position of New York as a financial center is appraised with the conclusion that "Perhaps no financial center . . . was ever called upon to perform such a huge task in the field of international finance with as little preparation . . . ."

The treatment of the London money market is more effective than that of the New York money market, although it has the same defect, namely, an inadequate discussion of certain phases of the subject. What is said about Treasury Bills and Bank Rate is good, but the discussion is not as full as could be desired. Happily, the authors have not been so brief as to omit vital matter such as the reference to " . . . the policy of maintaining a low bank rate favorable to trade and industry and to the attraction of foreign acceptance business (which) often clashed with the desire, and sometimes even with the necessity for maintaining a higher rate in order to prevent an outflow of foreign short-term funds."

The remainder of the volume is particularly welcome because it makes available in text-book form material which is scattered or else in a volume such as Willis and Beckhart's *Foreign Banking Systems,* now somewhat out of date. In the discussion of the Paris money market the authors are not disposed to be critical of the policy followed by the Bank of France from the middle of 1929 to the middle of 1931, for the bank " . . . apparently made no effort to withdraw balances from London until the last hope of maintaining the stability of the pound sterling was abandoned." (p. 317) Ap-

[1] *Gold and Prices.*

parently the authors would not agree with the view of Einzig.[1]

The chapters on Berlin as a money market should be welcomed by every teacher of finance because of the dearth of material (outside publications in the German language) on recent developments there and also because of brief but penetrating references to such matters as the method of direct pressure used by Dr. Schacht upon the members of the Berlin Stemple-Vereinigung. (p. 386) There is an excellent chapter on Berlin "Private Credit Banks and the Operation of the Market," which includes some material on the Bank Law of 1934. Its chief merit, however, lies in the fact that the position of the private credit banks is set forth in a manner readily understood by American students, a thing that cannot be said by those European writers who are quite unfamiliar with the background, on banking subjects, of American university students.

The peculiarities of Dutch financial practice are explained in a way which is helpful to an understanding of the Amsterdam money market. It is also made clear that "The strict supervision of the acceptance business by the Netherlands Bank has been an important factor in the development of the Amsterdam bill market." In the chapter on "The Swiss Money Market," the conditions under which the National Bank will redeem its notes and other unique features of banking practice are well presented. The reasons for the relative unimportance of both the Amsterdam and the Swiss money markets are also brought out along with the effect of the German influence, particularly in the latter country. (p. 512)

Taken as a whole, the volume should be well received by those teachers of banking and finance who take up foreign banking systems with their classes. It is clear, well organized and does not assume an understanding of European banking practice which American students do not have. Moreover, it takes into consideration developments as recent as 1934 in those money markets which are chiefly concerned with the financing of the world's trade and it is, therefore, timely.

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Myself. John R. Commons. (New York: The Macmillan Company, 1934. Pp. vii, 201. $2.25.)

Institutional Economics. John R. Commons. (New York: The Macmillan Company, 1934. Pp. xiii, 921. $4.00.)

The writer of this review suggests that the little book, *Myself* be read before reading *International Economics*, because of the excellent personal impression that can thus be formed of the author of both volumes. The former seems to have been inspired by Dr. Commons' "Friday Niters," a group of graduate students and seniors with which he "... has been meeting for the past thirty years." *Myself* is the story of the genesis of his ideas and their end is found in "... my Institutional Economics and the third volume of History of Labour in the United States." The reader of *Institutional Economics* should not overlook the passage in *Myself* (p. 44):—" ... I always thought that both political science and sociology were branches of political economy."

Early in his career Dr. Commons learned "... to distinguish capitalists from 'capitalism' and labor leaders from 'labor'," and that bit of discrimination proved to be as valuable to him as it should now be to other economists. It led him to say that "I should like to see them (capitalists) in control of industry," and it also enabled him to say of Insull, "I stood up for him, with my conservative friends, as the victim of American capitalism. ..." It is quite evident from the interesting chapter, "Wisconsin," that the years of his remarkable service in that state provided him with the laboratory wherein his ideas were largely tested and these ideas emerge as "Institutional Economics." But it is unfortunate that a life so rich in vital experience should be so inadequately revealed. Undoubtedly he had possession of material sufficient for a remarkable and much needed biography which would more adequately express the measure of his influence upon his time.

Out of the rich background, clearly yet too briefly revealed in *Myself*, came the material for *Institutional Economics*. There are only eleven chapters in the latter volume but some of them are long. Thus, the chapter entitled "Futurity" extends from page 390 to 648 and it covers a vast range of ideas. However, the central idea is never lost sight of nor is there a lack of continuity in the thinking about it. Early in the treatise he remarks, "Not until it became vaguely felt by the heterodox economists in the middle of the Nineteenth Century ... that ownership and materials were not the same thing, were the beginnings laid for institutional economics." The method employed by Dr. Commons involves a close analysis of the ideas of many thinkers, beginning with John Locke, whom he regarded as "... the spokesman of a Revolution that changed England from Feudalism to Capitalism." He gives close consideration to the double meaning of "... Ownership and Material Wealth (that) continued to be the meaning of the orthodox economists for two hundred years."

As for institutions, they are the "... going concerns with the working rules that keep them a going, all the way from the family, the corporation, the trade union, the trade association, up to the state itself ...." But he admits the difficulty of defining "... a field for the so-called Institutional Economics (in) the uncertainty of the meaning of the word institution." But "Analysis of collective sanctions furnishes that correlation of economics, jurisprudence, and ethics, which is prerequisite to a theory of institutional economics," and analysis is vigorously prosecuted throughout the volume, particularly from the writings of Hume, since "Institutional economics goes back to Hume."

Thus it becomes possible to define an institution as "... collective action in control of individual action ..., collective action in restraint, liberation and expansion of individual action." But we are reminded that "... institutional economics is legal control of commodities, of labor, or any other economic quantity, whereas the classical and hedonic theories dealt only

[1] Einzig, Paul. *The Fight for Financial Supremacy*, p. 117.

with physical control." Here then is the basis of the philosophy that runs through the entire volume and also the inspiration of its effort to develop a theory of economic value that is valid. To this end Dr. Commons works with intensity, bringing to bear the knowledge, experience and thinking of a lifetime and the outcome is a truly remarkable volume.

However, not all contributors to economic thought are taken into account, for the author's analysis is confined to those "... whom we name Pioneers of New Insight." (p. 121) The first of these is Quesnay who had the insight to recognize that "... the physical and scarcity concepts were contradictory." More important, however, was Quesnay's idea of natural law, natural right and natural order which was merely "... the Custom of the time and place ...," and custom is one of the institutions recognized by Dr. Commons. Hume and Pierce are included because Pierce perfected the method of Hume. Hence Dr. Commons follows Pierce and accepts "... the term Pragmatism as the name of the method of investigation which we attempt to apply to economics in this book."

There follows an excellent analysis of Smith's conception of value and from it is derived this thought—"It is this scarcity-value which we name proprietary scarcity, and we have three historical stages in the meaning of scarcity: Smith's psychological state of resistance of the laborer to labor-pain; Ricardo's materialistic resistance of nature to Smith's labor-power for low wages." According to Dr. Commons, "Smith assumed that, when this legislative scarcity should be eliminated then all scarcity would be eliminated by becoming identical with quantity of labor-pain." The author's analysis of Smith's views brings him to the conclusion that they contribute nothing to institutionalism. The "... theories of Smith and his imitators for a hundred and fifty years ..." are named "fundamentalism," (p. 216) because they rested on the feelings of Man and God. Transactions and customs were too superficial.

The analysis next passes to "Bentham versus Blackstone," because "Bentham was really the founder of Nineteenth Century economics, divorced from law, custom, and ethics." Thereby, Dr. Commons is enabled to bring out the defects in their views of custom. Both looked for custom in the past, whereas "... custom is also *expectation*, based on experience, that practices will be repeated in the future...." In other words, Dr. Commons evolves from his examination of the views of Bentham and Hume one of the cornerstones of institutional economics. Indeed, this is the method pursued throughout the treatise and it is both enlightening and challenging.

Malthus is described as "... the first scientific economist ..." because he derived by investigation, the economic principle of scarcity and scarcity has a large place in the evolution of institutions. And there follows a long chapter, "Efficiency and Scarcity" in the course of which it is brought out that "... Scarcity-value is prices paid for legal control measured in terms of money. Value itself is assets, or the value of ownership. ..." Further along, it is said that "... there are two kinds of objective values, physical use-values and proprietary scarcity-values. ..." Upon this distinction Dr. Commons builds his conception of "... Capitalism, the double process of creating use-value for others and restricting its supply so as to create scarcity-value." Production has the antithetic meaning of production and withholding production. Ricardo and Malthus come in for careful examination against the background of these views. To the latter value "... was scarcity-value determined by bargaining ...," but for Ricardo scarcity-value was only "nominal value." They held two meanings of demand and supply which persist to the present day. (p. 362) The issue is clear and also the means of reconciliation, for "The things delivered in this business process of bargaining are not physical commodities, they are the legal forms of ownership," a fact recognized by J. S. Mill who buried the labor theory when he "... quietly substituted money-cost for labor-cost, scarcely realizing what he had done."

Passing to "Futurity," Dr. Commons leads off with the statement that "... releasable debts became the foundation of modern capitalism," and then proceeds to analyze MacLeod's conception of property and property rights, for MacLeod was misinterpreted since he did not "... count the same thing twice, once as a physical commodity and once as an expectation of debt payment secured by a mortgage upon that physical commodity." He merely failed to count the liability side as existing at the same time as the asset side. (p. 412) Hadley was not confused in this matter, for he was "... the only one of one hundred and seventeen economists who defined price as the price of a 'right'." Thereby he became an institutional economist. But it remained for Hawtrey not only "... to distinguish a debt from a commodity, but to unite the two in a single transaction," a price on the commodity market determining the magnitude of a debt on the money market. (p. 483) Accordingly, we find Dr. Commons saying that money is secondarily a medium of exchange and primarily a social means of creating, transferring, and extinguishing debts. In addition he is led to distinguish the transactional, purchasing-power and distributive meaning of value. (p. 520) Finally, it becomes possible to say that there is an economic object which is both psychological and objective, but not a commodity. Thus collective action becomes an object which can be made a subject matter of economics. Indeed, it is the subject matter of institutional economics.

Perhaps the most effective portion of the treatise is to be found in the analysis of "Sales Forecast" and following matter, for here it is brought out that "... *expected* profit determines the amount of *present* purchasing power. ..." Moreover, the purchasing power disbursed is identical with the value of the material and labor purchased *at the time when purchased*. Carrying the analysis further, he finds it necessary to look elsewhere "... for the causes of overproduction and unemployment, which we shall find, not in the *share* of profit but in the *margin* for profit...." Moreover, "... our capitalistic system is conducted on amazingly

narrow margins for profit. . . ." Indeed, the margin for profit becomes the whole thing. (p. 580)

Finally, Dr. Commons is brought to "Reasonable Value," a subject which fits into the preceding discussion most appropriately. He traces the rise and development of judicial recognition of Veblen's distinction between "capital as the value of corporeal property . . . and the new phenomenon of the value of intangible property." Out of this discussion he reaches the conclusion that " . . . property is the monetary capitalization of earning power and this capitalization is modern capital." (p. 663) Dr. Commons' analysis of Veblen leads him to say that he was " . . . the pioneer of institutional economics, next to MacLeod. . . ." Unfortunately, he did not have the advantage of the conclusions afterwards worked out by the courts; he did not see the institutional idea of reason and reasonable value reach its " . . . pinnacle in the sovereignty of the Supreme Court. . . ." (p. 682) Just what Dr. Commons is really driving at in his study of reasonable value emerges, when he says that, " . . . if we rest our search for uniformity upon the transactions of many going concerns, instead of upon individualistic emotions, then we do have many similarities of which we can understand, . . . *why* they are uniform—because they are similarities which we know by experience." Thus, " . . . the capricious and lawless subjective value or will of Weber, which is incapable of the uniformities required by science, is displaced by similarities of valuation and willingness which are the subject of both jurisprudence and economics."

Careful reflection upon the entire treatise leads one to the conclusion that Dr. Commons is trying to work out a more complete theory of value with institutional objectiveness and when his work is viewed from this angle it becomes highly significant and it is not too much to say that he has made a brilliant contribution to the literature on the theory of value.

There follows a discussion of Morton's views on unemployment insurance and an interesting chapter on "Communism, Fascism and Capitalism," but the real substance of the treatise was completed before these were added. This reviewer does not hesitate to say that every student of economics should digest this volume with care for he will find here an attempted rationalization of a vast fund of knowledge and wisdom accumulated in the course of a long and highly useful life. Old ideas are given a new meaning and vitality and the best in economic thought is carefully reappraised with the thought that a theory of value that has validity in terms of modern capitalism can be evolved. There will be much difference of opinion as to whether or not Dr. Commons has achieved what appears to be his purpose, but there cannot be much question about the profound and brilliant effort that he has made.

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University of Virginia

Gold and Prices. George F. Warren and Frank A. Pearson. (New York: John Wiley & Sons, Inc. 1935. Pp. vii, 475. $5.00.)

The authors frankly admit that "Much of the material in this volume is taken from *Prices* but so many new chapters have been added and such extensive revisions have been made, that it is deemed advisable to give it a new name so that the two books can be distinguished." But it is still their purpose " . . . to add something to the science of economics, something to the dissemination of knowledge, and to help individuals in their immediate problems. . . ." And it may be said that they have succeeded with respect to the two latter objectives, even though there may be much difference of opinion with respect to the first. In any event, the authors early commit themselves, for " . . . stabilization of the purchasing power of the monetary unit is necessary to solve the most serious of the price problems." Thus it becomes apparent that price problems are considered as essentially monetary in nature. This becomes more apparent when they say that, "The low demand for gold during World War period caused prices in the United States to more than double." (p. 18) Again, it is said (p. 71) that "Production does not explain the great price movements either for one country or for all countries. It will be shown later that the supply of and the demand for gold does readily explain the major price movements." The position of the authors becomes increasingly definite. Thus, they say (p. 86) that "In 14 years (from 1920) the value of gold changed from the lowest to the highest level known in the history of the United States. . . . Prices rose to correspond with the low value of gold. The attempt to adjust the whole debt and tax structure suddenly to the highest value for gold that the country had ever experienced resulted in economic collapse."

For the most part, the authors rely upon secular correlations. Thus, it is said (p. 91) that, " . . . prices for 75 years before the war were generally very close to the quantity of monetary gold divided by the quantity of other things." And it should be added that nearly all such statements are accompanied by charts and tables designed to support them. But it is admitted that "Short time fluctuations are affected by . . . weather, livestock cycles, business cycles, and . . . some other causes." These "other causes" are not discussed. Maldistribution of gold does not appear to be one of them for it is said that, "The value of gold was determined primarily by world supply and world demand, not by location." (p. 106) Moreover, the value of gold is admitted to have cyclical influence, since, "The gold panic of 1929 and the collapse in the price structure were due to a sudden world-wide return of the demand for gold." As one works through this volume, it becomes increasingly evident that maladjustments on the goods side may be due to causes other than the changing value of gold, and failure to recognize this is the chief weakness of the analysis.

Increased efficiency in the use of gold may be a fact yet " . . . gold had to increase with the production of other things to maintain stable prices. A fact cannot be explained away." (p. 137) Unfortunately, there is no analysis of the excellent evidence prepared by outstanding economists that increased efficiency was a factor. It is also maintained that, " . . . the ratio of bank credit to the physical volume of production in the United

States does not explain commodity prices . . . for credit cannot control prices when a country is on a gold standard." One cannot accept this conclusion of the authors until they have at least analyzed the relationship of bank credit to prices.

The arguments advanced in support of the primacy of the value of gold as a price factor lead the authors to support devaluation of the dollar as the solution of depressed prices. Thus, they hold that, "If the weight of gold in the dollar is suddenly changed, it does not change the ratio of gold to cotton, but does change the ratio of dollars to cotton, even though there has previously been no change in the amount of bank credit, monetary circulation, or velocity." (p. 144) The question not answered is, how soon? There follow chapters on "The price of Gold" and "Effects of Changing the Price of Gold," and in the latter (p. 184) it is said that, "Apparently, the United States has obtained practically the full advance that is to be expected from the change in the price of gold." But, there is no accompanying analysis which makes this alleged fact apparent, consequently nothing by way of explanation of the recovery of prices in so far as they may be attributed to factors other than devaluation.

As for inflation, its meaning seems to reside in the statement—"When a price structure is approximately in balance, rising prices cause an unbalanced situation, because raw materials rise faster than finished products, wages, freight rates, taxes, debts, or costs of distribution." (p. 195) But there is no reference to the fact that maladjustment may be due to the allocation of bank forced loans or to other factors quite removed for the time being from the value of gold. Deflation as a method of attaining equilibrium brought the United States " . . . to a state of complete financial paralysis as well as social upheaval," and it is charged that Secretary Wallace " . . . repeats the popular error that establishing an equilibrium in the price structure is a separate problem from restoring the general price level." In other words, equilibrium can be achieved only by devaluation. The authors also reject controlled production, " . . . until vastly more research work in economics is done and the result taught—widely . . . . " Accordingly, it is gratifying to read that, "The net result of the plan of crop destruction is apparently of doubtful value in increasing the gross income of the south, a tax on consumers of nearly a dollar per capita, and a stimulus to cotton production in other countries."

The authors appear to recognize the significance of prices set by administrative act for they assert that " . . . the practice of set prices spread with great rapidity until it became the accepted business philosophy of America," and they feel that a society in which such a condition prevails must " . . . finally be based on compulsion rather than competition." (p. 233) But there is no reference to the excellent work of Dr. Means[1] nor is there a discussion of the effects of devalution under such conditions. In their "Comparison of Panics," it is said that "The tide turned in 1933, when the gold standard was abandoned . . . ." The authors appear to favor a "Stable measure of value" and hold that "The scientific method is some form of an all-commodity, or many-commodity, dollar." With such a dollar many problems could be at least partly solved. Thus, it is said (p. 371) that "Most of these violent fluctuations in relation of taxes to income are due to fluctuations in the value of gold." There is only one way to make taxes easy to pay and that is to "restore the price level . . . ." The correlations of the price of gold with foreclosures and marriages may be accepted as statistical facts, but there still remains the necessity of accounting for the correlations, since the mere correlations are not proof of anything except the correlations. (Ch. XXI)

All sorts of economic events and tendencies are explained in terms of the price of gold. Even the stock market boom is so accounted for. Thus, it is said (p. 423) that "As a result of this unstable value of gold, many persons came to look on common stock as a very safe investment." Doubtless the authors mean that the unstable value of gold was at least a subconscious factor, but even that may be questioned. In conclusion it may be said that this volume contains much valuable and significant statistical data which throw light on certain price situations. But it is not possible for this reviewer to accept it as a scientific treatise on money, because it does not analyze all of the factors making for price disequilibria. Rather it places undue emphasis upon the value and price of gold, thereby failing to give adequate consideration to other factors involved. The value of gold is at the root of every maladjustment and devaluation is the remedy. This is far too simple. Hence it may be said that this book will be received as a valuable study of gold as a price factor, but not as an explanation of prices except in the secular sense, even though it is evident that the authors intend that it shall be considered as sufficient explanation of price movements of less duration. Mention should also be made of the rather full documentation and excellent chapter bibliographies.

E. A. Kincaid

University of Virginia

Control of the Retail Units of Chain Stores. E. H. Gault. (Ann Arbor: University of Michigan Bureau of Business Research, 1935, Pp. iv, 99. $1.00.)

Since 1920 there has developed an extensive literature on the problems of control among department stores and specialty shops. The Controllers' Congress and the Merchandise Managers' Division of the Nation Retail Dry Goods Association along with Bureaus of Business Research in the Universities have contributed extensively in the way of articles and monographs on this topic. With the background of that literature in mind, the reader can use effectively the assembly of facts which Professor Gault of Michigan has presented in *Control of the Retail Units of Chain Stores.*

The data for this study on the control methods employed by the central offices of chain stores were obtained from 62 different organizations of varying size, representing 16 different types of merchandise in local, sectional, and national retail chain stores. An attempt was made to determine, first, what the control methods

[1] Senate Doc. 13, 74th Congress, 1st Session.

were with respect to merchandising, inventory, finance, and personnel and, secondly, to indicate what conditions affecting a chain store are influential in determining the control methods that it uses.

In a space of 99 pages, it would be impossible to present a thorough description of the details of a variety of control systems for each of the four phases of control studied, but granted that the reader has some elementary knowledge of systems, Professor Gault has been able to describe briefly the practices of many companies on these several questions. By providing a statement on products, locations, and other pertinent points of differentiation between chains studied, he has established a factual basis for many of the conclusions which he states.

Professor Gault finds nothing unique in the technique of control. Every device used by chain stores has been used in other types of retail stores. The remarkable growth of chain stores is not attributed to control, nor does a good control mechanism insure profitable operation. He suggests that chain stores which use the methods of control similar to those in department stores have had a more profitable recent history because the chains have expanded sales volume by opening new outlets rather than by following the department store method of increasing sales by intensive sales promotion methods and elaborate services to customers. The influence of size of chain, size of individual outlet, location of outlets, nature of merchandise handled, the capacity of executives, and the organization of chains as they affect methods of control are summarized in the separate chapters on each control topic and in the concluding chapter.

Edward P. Learned
Harvard Graduate School of Business Administration

Liquid Claims and National Wealth. A. A. Berle, Jr., and Victoria J. Pederson. (New York: The Macmillan Company, 1934. Pp. xvi, 248. $2.50.)

This "explanatory study in the theory of liquidity" attempts to trace through our varied economic pattern two separate but related types of liquidity. These two types are "real" and "artificial" liquidity. "Real" liquidity exists when an asset can readily be converted into cash because (a) the asset enters into human consumption, (b) the asset is destroyed through such use, and (c) the asset is normally replaced by new production. "Artificial" liquidity exists when an asset can be sold only through the aid of some financial mechanism, or when an asset can be sold only after a relatively long period of time. Credit instruments may fall into either classification depending on the type of security which supports them.

Much of the theory developed in this volume is woven around, and supported by, the quantitative studies of the authors. This is particularly true of the statistical data relating to liquid claims, and the percentages which such claims represent of national wealth. The totals for liquid claims include bank deposits, cash surrender value of life insurance policies, and domestic stocks and bonds listed on the New York Stock Exchange, but excluding financial securities. The totals of these items (adjusted) range from a low figure of seven billion in 1880 to a high of one hundred thirty-seven billion in 1929. This total had dropped to eighty-seven billion in 1933.

The increase in liquid claims is emphasized not because of the actual increase in dollar values of these items but because liquid claims have been increasing faster than has our national wealth. This is indicated by the ratios of net liquid claims to national wealth which range from a low of fifteen per cent in 1890 to thirty-eight per cent in 1929, forty per cent in 1930, and thirty-four per cent in 1933. The authors consider this trend as representing an understatement of the case and when the statistical appendices are examined this conclusion seems warranted. In fact the understatement may be much greater than the authors have indicated. Two large classes of securities have been omitted, those securities which are listed on exchanges other than the New York Stock Exchange, and securities traded over-the-counter. Recent estimates have valued the over-the-counter securities at approximately fifty-five billion dollars. Likewise, the securities listed and traded on exchanges other than the New York Stock Exchange are valued at a large amount. At the present time these securities have a value of approximately twenty-five billion dollars. The New York Stock Exchange does dominate the security market in the United States but this exchange accounted for only sixty-one per cent of the security trading in 1929 and seventy-six per cent in 1932.

The ratio of net liquid claims to national wealth, as given by the authors, is the basis for many of their arguments, and they particularly emphasize the changes which have occurred since 1929 in the security markets. The ratio of stocks and bonds (less financing) on the New York Stock Exchange, to national wealth, was twenty-eight per cent for 1929 and 1930, twenty per cent for 1932, and twenty-one per cent for 1933. Thus, it is pointed out, the high ratio of liquid claims has been maintained in spite of drastic price declines. This situation is explained by reference to the increasing number of shares and issues placed on the market during the years 1929–1933 representing the "translation of fixed assets into the corporate form and its reappearance as shares. . . . "

The authors have devoted some attention to the policies which should be followed if we expect our economic system to continue as it exists today, but with the increase in liquid claims continuing at the rate prevailing since 1880. Three specific suggestions have been advanced to strengthen our financial organization: (a) the reorganization of our banking system for the purpose of separating the stream of "real" and "artificial" liquidity; (b) the creation of a central bank to support our security markets; and (c) the reduction of speculation in the stock exchanges. It seems that some of these suggestions have already been adopted in the 1934–1935 legislation concerning banks and exchanges.

There is considerable repetition in this volume and some parts of the discussion might well have been omitted, such as the treatment of banking functions,

portfolios, reserves, and underwritings. However, the problem of liquidity is outlined, some interesting statistics compiled, and a start is made towards the development of a body of theory covering the subject of liquidity.

FRANK P. SMITH
University of Rochester

Operating Results of Department Stores in the Pacific Coast States: 1934. Carl N. Schmalz. (Boston: Harvard University, Graduate School of Business Administration, Bureau of Business Research. Bulletin 97. Pp. v, 18. $.50.)

This report on the margins, expenses, and profits of department and specialty stores in the Pacific Coast states is based on figures reported by sixty-five firms operating more than ninety-six stores in Washington, Oregon, and California. Practically all the data on which this bulletin was based were also used in preparing Bulletin 96. The operating results of the stores are presented in ten tables. The figures in the tables must be interpreted with care because a relatively small number of firms reported and this number had to be divided into comparable groups. This is especially true for the tables presenting specialty store data, for usable reports were received from only seven specialty stores. Professor Schmalz makes the following comment on specialty store figures: "The figures are published here in the hope that they will be of some service to store executives and will aid in arousing interest in this work among specialty stores in the Pacific Coast states so that a larger number of reports will be received in the future."

The department store figures for the Pacific Coast stores follow closely the nation-wide figures published in Bulletin 96 and in earlier bulletins, and detailed comparison with these figures is given. Since 1934 is the first year for which Pacific Coast figures have been prepared in the form here presented, directly comparable figures are not available for 1933. However, the Harvard Bureau of Business Research did issue in 1933 three tables summarizing the operating results of a number of groups of Pacific Coast stores, and a comparison of the 1934 figures with those tables affords some idea of the changes which have occurred.

One section of the bulletin is devoted to the relation of appeal and character of clientele to department store operating results. In this section a study of eight stores is made. Three of the eight stores used price appeal primarily and were classified as medium and low-medium with respect to clientele and price lines. The other five stores stressed quality more than price and were classified as high-medium or high with respect to clientele and price lines. The section compares various features of the two typesof storesand also their margins, expenses, and profits. Bulletin 92, which was issued in 1933 and is comparable to this year's Bulletin 96, contains a similar section for stores in all sections of the country.

This bulletin is of value to Pacific Coast department store operators in that it does make available to them some regional operating results and may serve as a basis for the development of more reliable standards by which they can measure their individual performances. If such standards are to be properly developed, the stores in the Pacific Coast region will have to coöperate with the Harvard Bureau of Business Research to the fullest extent in supplying data on which future bulletins may be based.

T. KENNETH HAVEN
University of Michigan

Operating Results of Department and Specialty Stores in 1934. Carl N. Schmalz. (Boston: Harvard University, Graduate School of Business Administration, Bureau of Business Research. Bulletin 96. Pp. vi, 42, $2.50.)

The operating results of department and specialty stores in 1934 constitute the subject of the fifteenth consecutive annual department store study published by the Bureau of Business Research of the Harvard School of Business Administration. The report is of special interest because it reflects the results of a full year of operation under NRA and because it reports the first increase in dollar sales over sales of the previous year since 1929. Net sales for the various groups of department and specialty stores in 1934 were from 6 per cent to 18 per cent larger than sales in 1933. The average increase in sales for all reporting firms was 11 per cent. The improvement in dollar sales is reflected in the improved earnings which were reported by stores of practically all sizes. Moreover, 1934 was the first year since 1930 in which a profit after interest charges was shown for any of the ten groups of department stores studied.

The bulletin presents the operating results of the stores in twenty-eight tables and two pages of charts, most of which have been prepared in the customary manner. There are, however, three new features: (1) A section is included which discusses trends in dollar expense during the depression. In this section four tables are presented, each showing for a group of similar-sized firms the course of both dollar expense and percentage expense for the past five years. (2) A new arrangement of some of the tables has been effected to show the separation of expense data from merchandising and profit data. (3) There is a more detailed breakdown of the specialty store reports by sales volume. Figures on the merchandising operations, expenses, and profits of specialty stores are presented for five sales-volume groups, whereas in previous years only three groups were segregated. The present bulletin also gives information on average sales and on expense and profit per transaction which was not available in last year's bulletin, and the statistics on functional expense are presented in more usable form. While all of these changes are improvements, the effect of changing the number of sales-volume groups does make comparisons with the 1933 figures more difficult.

These three new features do not, of course, constitute the only innovations in the study. Two tables are devoted to showing the operating results of department and specialty stores in 1934 according to the new form of income statement approved by the board of directors of the National Retail Dry Goods Association. This new

form also has the approval of the Securities and Exchange Commission.

The bulletin brings out clearly the fact that in 1934, as in 1933, small department stores were practically on a par with the large stores as regards earnings. The same was true of specialty stores in 1934, the first year for which detailed figures are available. This tendency for the large stores to show no more favorable earnings than do the small stores represents a pronounced change from conditions prevailing before the depression, when, year after year, the earnings rates of the larger stores were higher than the earnings rates of small stores and when the percentage of net profit on merchandising operations tended to vary directly with size of store. Professor Schmalz points out that, while this tendency must prevail for more than two years before it can be considered a permanent shift, the fact of its existence during the past two years is important to large stores as indicating that some unfavorable change is taking place in the underlying competitive situation or in demand.

Like previous bulletins, the 1934 bulletin makes no attempt to suggest specifically how stores may operate more successfully. It does, however, serve as an excellent yardstick with which department and specialty store operators can measure their own performance. The bulletin also answers with facts and figures many questions that are constantly confronting merchandise managers. Furthermore, Professor Schmalz, in his discussion of the tables and charts, clearly presents the changes that are taking place and makes valuable comments as to their nature and permanency.

T. Kenneth Haven

University of Michigan

Legal Responsibilities and Rights of Public Accountants. Wiley Daniel Rich. (New York: American Institute Publishing Company, Inc., 1935. Pp. xii, 236. $2.50.)

This timely little book should be read by all present and prospective practitioners of public accounting. It serves to collect all of the laws on the subject in England and the United States to date. The material is presented in four chapters. Chapter I deals with the Liability of the Public Accountant for Negligence, Fraud and Libel. It affords a more complete treatment of this important subject than is found in the ordinary Auditing text. Chapter II deals with the Law and the Certified Public Accountant's Certificate. This section is of interest principally to practitioners within the United States. In the third chapter the topic of discussion is The Admissibility of the Public Accountant's Expert Testimony in Court. A general knowledge of law is helpful for one who would really understand the legal technicalities involved in this chapter and the next. If this volume is to be used in schools as a text, therefore, its place in the curriculum should, if possible, follow a general well-rounded course in commercial law, and the instructor should have a thorough legal training. The material in Chapter III should be of help to the legal profession in obtaining a preliminary idea of accounting evidence to be presented in court in a specific case. Accountants, moreover, will gain from a study of it better ability to coöperate with the legal profession as witnesses in court. In the final chapter on Some Rights of Public Accountants the subjects dealt with are Champerty, Ownership of Working Papers, The Accountant's Lien upon his Employer's Books, Rights of the Public Accountant under United States Bankruptcy Act, Expenses of Audit in Addition to Personal Services of Accountant, Nature of Accountant's Services Affect Reasonableness of Charges, Auditing Contracts with Corporations and Governmental Agencies, and Powers of Practitioners of Public Accountancy to Incorporate. The reviewer was especially impressed by the statement under Nature of Accountant's Services Affect Reasonableness of Charges on page 222: "Two decisions, one by the Louisiana supreme court[47] in 1928 and the other by the Louisiana court of appeals[48] in 1929, placed high values upon accountants' income tax services, which the judges classed as legal as compared to values placed upon the usual auditing work which the judges thought was clerical." It appears that the job of educating outsiders to the true significance of the best public accounting work, at least, is not yet complete. The volume closes with the Rules of Professional Conduct of the American Institute of Accountants, a table of cases, a table of statutes, and a bibliography. In the opinion of the reviewer this volume is among the most welcome of the publications in the field of accounting during these past several years.

Arthur W. Hanson

Harvard Graduate School of Business Administration

Auditing Procedure. Second Edition. DeWitt Carl Eggleston. (New York: John Wiley & Sons, Inc., 1935, Pp. xviii, 488. $4.50.)

Although this edition has fewer pages than its predecessor it appears to be an improvement for the purpose of imparting to students the general principles of Auditing. The chapter headings, the topics dealt with in each chapter, and the number of pages in each chapter, are identical in both editions for the first 405 pages. Such changes as the reviewer could find in these 405 pages were inconsiderable. The last hundred odd pages of the old edition were devoted to Hotels, Restaurants, and Clubs; Retail Store Audits; Institutional Revenue and Expense Accounts; Theatres and Amusement Enterprises; Municipal Audits; Bank Audits; Savings and Loan Associations; Brokerage Audits; Insurance Companies; Fraternal Benefit Associations; and an Appendix—Auditing Problem.

Instead of dwelling on the auditing peculiarities of these particular types of business in the new edition, Professor Eggleston has followed the lead of Montgomery in the fourth revised edition of his "Auditing Theory and Practice" where he confined himself to general auditing principles and practices. Pages 406 and 436, inclusive, of the new edition are devoted to an illustrative report and working papers on a book-publishing business. Although the working papers are not complete, probably enough are given for all prac-

tical purposes of class instruction. Pages 437–471, inclusive, contain 167 supplementary problems. An appendix, pages 473–477, inclusive, contains an abstract of a paper on Mechanical Features of Accountants' Reports and Working Papers presented by Professor Eggleston before the New York State Society of Certified Public Accountants. The book closes with a ten-page index.

ARTHUR W. HANSON

Harvard Graduate School of Business Administration

Fundamentals of Accounting. E. A. Saliers. (Chicago: Business Publications, Inc., 1935, Pp. 424. Publisher has informed us the correct price of the text edition is $3.50, and practice set forms are available at $1.00 complete.)

This book reads both smoothly and accurately, the language used reflecting somewhat a philosophical treatment. One may well believe that, as suggested therein, the students who have used this book in the author's college developed a remarkable interest in the subject of fundamental accounting principles.

The book covers accounting elements applied to the businesses of sole traders, partnerships, and corporations. The chapters are each broken down to give first, a discussion of fundamentals to be studied, with illustrations; then, a summary of the high spots, and lastly, review questions. The laboratory work consists of five practice sets, these to be worked as progress is shown.

The approach is the usual one: Property, debts and wealth; net worth; changes in net worth; profit and loss statement; and so on. Undoubtedly, for beginners, some other approach would be simpler, inasmuch as the one used is believed by the reviewer to be the most difficult of all for the student to square himself against. There are twenty-nine chapters in all.

However, there is no question but that a careful study of this text will provide a solid foundation upon which to build the student's further knowledge of the subject of accounting.

GEORGE E. BENNETT

New York Laws Affecting Business Corporations. Sixteenth Edition, Revised to May 17, 1935. Edited by J. B. R. Smith. (New York: United States Corporation Company, 1935, Pp. 520.)

The sixteenth edition of this important publication, like its predecessors, is prompt, accurate and compact. It is more of a handbook than a text, being of ever-ready desk value to anyone interested in the organization and the statutory regulation of private business corporations in New York state. It is impossible to believe that such professional and business men cannot realize the value and worth of a book like this one when they learn that at the recent legislative session, forty-one separate acts were adopted changing eighty-nine sections of the Consolidated Laws as covered by this publication. Also, the notes herein found set forth the exact language of the Court in the latest Court of Appeals decisions.

The synoptic analysis is retained in this edition, this being a most excellent "topical arrangement of the more important features of the general and the stock corporation laws, of the corporation tax laws and the relation the several corporation laws have to one another."

Just how the corporate accountant in this state can do his work efficiently and correctly without an up-to-date knowledge of many of the things found in this book seems impossible to explain.

GEORGE E. BENNETT

Accounting Principles. McKinsey and Noble. (Cincinnati, Ohio. Southwestern Publishing Company, 1935. pp. 751.)

"The revised edition of *Accounting Principles* is definitely planned to serve four groups: (1) those who expect to continue the study of accounting and to practice it as public or private accountants; (2) those who expect to enter business activity and wish a better understanding of accounting as a tool of business; (3) those who are interested in economic society and who believe that a sounder understanding is available through a study of accounting; and (4) those who anticipate entering the professions and expect to apply accounting to their own needs."

In this new edition the basic subject matter is developed more quickly and considerable additional material has been added to the study of partnerships, corporations, manufacturing, and accounting for non-profit organizations. Some entirely new chapters are now included on the subject of cost accounting, consolidated statements, accounting for creditor control, and supplementary statements. The book contains thirty-three chapters with an average of about twenty-three pages per chapter including the questions and short problems for class discussion and also laboratory problems. Three shortened practice sets, which are optional, are included.

The first four chapters treat the beginning fundamentals of bookkeeping. The balance sheet approach is used for the analysis of transactions. The sections and items of a complete balance sheet and profit and loss statement for a trading concern are defined and classified. The student is introduced to the ledger, the use of accounts for balance sheet items and the preparation of a trial balance. Chapter V introduces the use of temporary proprietorship accounts and the closing of the books is mentioned but not yet illustrated. An eight column working sheet, which includes adjustment columns but no second trial balance columns, is illustrated. From the working sheet a balance sheet and a profit and loss statement are prepared.

Chapter VI illustrates the general journal, posting, and again the trial balance and working sheet. Chapter VII is called "Adjusting and Closing Entries" but the treatment of adjustments is incomplete because only merchandise inventories and office supplies are adjusted. The Profit and Loss Summary is prepared, the balancing and ruling of ledger accounts is well illustrated, and a post-closing trial balance is prepared. Chapter VIII is on the use of additional accounts as Notes Payable,

Sales Returns and Allowances, Freight In, Freight Out, Purchases Returns and Allowances, additional expense accounts and their classification in the profit and loss statement. Various books of original entry, other than the general journal, are illustrated in Chapter IX. Controlling accounts and cash discounts are explained in the next two chapters and practice set number one begins. In the next three chapters we find the entries for Interest and Discount (including the discounting of interest bearing notes), Notes Receivable Discounted account, Dishonored Notes, valuation accounts (Reserves for Depreciation and Bad Debts), accounting for the disposal of fixed assets, and the adjusting entries for Accrued and Deferred Items.

Chapter XV, The Periodic Summary, is the coördinating and summarizing chapter of the first half of the book. The procedure followed is: preparation of a first trial balance, compiling of all data necessary for adjusting deferred, accrued, and valuation items; preparation of a complete working sheet, preparation of the profit and loss statement and the balance sheet from the working sheet, recording the adjustments in the journal, closing the ledger, preparing a post-closing trial balance and then the necessary reversing (re-adjusting) entries.

The next two chapters illustrate the following: various kinds of vouchers, purchase requisitions, purchase orders and invoices, credit memos, sales tickets and invoices, bills of lading, monthly statements of account, bank papers and negotiable instruments. Under the heading of "the routine of recording" we learn about the use of the sales register, check register, journal voucher register, credit memorandum register, petty cash book, notes receivable and payable registers, insurance register and a register of fixed assets. The two chapters on partnerships are well explained. The material includes, among other details, the formation of and the opening entries for a partnership, the division of profits according to six different methods, the admission of a new partner, bonus and goodwill when a partner is admitted, the dissolution of a partnership, the liquidation of a partnership by installments, and then practice set number two begins.

Corporation accounting is divided among three chapters. We find an explanation of common stock, kinds of preferred stock, no-par value stock, surplus and deficit; par value, book value, market value, and liquidation value of stocks; changing from a partnership to a corporation; using the Unissued Capital Stock, Authorized Capital Stock, Subscriptions Receivable, and Capital Stock Subscribed accounts; premium and discount on capital stock; various records peculiar to and necessary for corporate accounting; capital surplus; earned surplus; corrections for previous periods, entries for cash and stock dividends; a statement of surplus; entries for treasury stock and donated surplus; long term liabilities and the amortization of premium and discount; sinking funds and sinking fund reserves; the investments of a corporation, and a complete corporation balance sheet.

A working knowledge of a complete voucher system is presented in one chapter. The elements of cost accounting are presented in three chapters. These chapters cover general accounting as applied to a manufacturing concern, job-lot accounting with service departments, and process accounting. We find perpetual inventories, the use of working papers, financial statements, and capital and revenue charges in a manufacturing concern; and some excellent illustrations showing the flow of costs through ledger accounts.

The concluding seven chapters cover all of the material mentioned in this paragraph: accounting for a concern with departments so that gross profit of each department may be found; branch house accounting according to three possible methods and the preparation of financial statments. At the end of this chapter practice set number three is given. This set includes corporation accounting, departmental accounting including one department which has manufacturing operations, and the general use of the voucher system. Consolidated financial statements are explained in one chapter. Included in the discussion of non-profit organizations financial statements for a professional association and a university are given. The accounting for creditor control discusses insolvency, bankruptcy, statement of affairs and a deficiency statement. The chapter on supplementary statements includes the application of funds statement and a cumulative profit and loss statement. The analysis of financial statements covers comparative balance sheets and profit and loss statements with the percentages and also some of the important ratios, as current, acid-test, notes receivable to accounts receivable, notes payable to accounts payable, owned capital to borrowed capital, and capital to fixed assets. The last chapter is a discussion of accounting its relation to management. Budgetary control and auditing are discussed in this chapter.

Accounting Principles is a good book and should be examined and considered by all who are planning a change in college texts. A person who has absorbed all the practices and principles set forth in this book possesses a wide knowledge of business practices and accounting procedure.

W. E. Karrenbrock

University of Illinois

UNIVERSITY NOTES

University of California at Los Angeles

A College of Commerce has been established at the University of California at Los Angeles which is to begin activities in September 1936. Professor Howard S. Noble, head of the accounting department and president of the Association of University Instructors in Accounting, has been appointed dean of the new school.

University of Cincinnati

Professor Norwood C. Geis has been elected president of the Cincinnati Chapter of the National Association of Cost Accountants for the year 1935–36.

Mr. Ralph Bursiek has been added to the accounting staff of the College of Engineering and Commerce.

University of Denver

Mr. Harvey D. Willson has left the department to take a position as head of the department of accounting and director of the placement bureau at Dakota Wesleyan University, Mitchell, So. Dak.

University of Illinois

New assistants in the department are H. E. Breen, C. J. Gaa, E. G. Rutherford, and C. P. Slater.

Mr. Walter F. Frese has been appointed assistant to the chief accountant, Mr. G. E. Lukas chief budget officer, and Professor Hiram T. Scovill consulting accountant for the Resettlement Administration of the Federal Government.

Dr. P. M. Green has been named research accountant of the Federal Housing Administration, Washington, D. C. Professor Lloyd Morey has been appointed chief consultant in the financial advisory service of the American Council on Education.

The Accountancy Club continues to be the most active student organization on the campus. Average attendance at its meetings has been about 400.

University of Iowa

Hartwell E. Anway, instructor in accounting since 1931, has resigned to enter the field of public accounting in Michigan.

Harold B. Eversole, associate professor of accounting, has been elected vice president of the Iowa Society of C.P.A.'s.

Kansas State College of Agriculture

Mr. Carl Nelson, last year instructor in accounting at the University of Kansas and formerly instructor in accounting at the University of Minnesota, has taken charge of the work in accounting in this department with the rank of assistant professor.

LaSalle Extension University

Mr. Max Killough, C.P.A., has gone to Texas to engage in accounting practice. Mr. A. O. Champlin, C.P.A., a graduate of the University of Oklahoma, has been added as instructor.

W. B. Castenholz, dean of the resident school in accountancy, is now practicing public accounting under the firm name of W. B. Castenholz & Co., the firm of Castenholz and Dittmar having been dissolved.

A new extensive C.P.A. training course is being developed.

University of Minnesota

Mr. Judson O. Burnett, instructor in accounting for the past five years and a graduate of Iowa State University, has resigned to accept the position of assistant professor of accounting at Northern Montana College, Havre, Montana.

Mr. Albert Henwood, M. A. Michigan, who has been with the Detroit high schools for several years, has been added to the staff as instructor in accounting.

Mr. R. R. Sevenich, C.P.A., formerly instructor in cost accounting and auditing at Marquette University and now comptroller of the Farm Credit Administration of St. Paul, recently addressed the local chapter of Beta Alpha Psi on the use of control accounts and tabulating equipment in the farm credit organizations.

Mr. H. J. Ostlund, assistant professor of accounting, in October addressed the meeting of the National Wholesale Druggists at Sulphur Springs, W.Va., on the topic of uniform accounting. Mr. Ostlund has also prepared a pamphlet on Uniform Terminology in the Wholesale Drug Trade, which has been published by the Association.

University of Montana

Roger Johnston, assistant instructor in accounting, has left the department to accept a position in Washington, D. C. with the Federal Government.

College of the City of New York

Professor J. R. B. Byers has resigned his position as director of insurance of the Federal Housing Administration at Washington, D. C. to resume his work in the accounting department of the College.

Dr. John J. Neuner, assistant professor of accounting, taught at the University of North Carolina the past summer. Dr. E. I. Fjeld completed his work for the doctorate at Columbia in October. His thesis "Analysis of Financial Statements" will be published soon.

A course in Building and Loan Accounting will be offered this year.

Ohio State University

Professor H. C. Miller was reelected President of the Ohio Society of Certified Public Accountants at their recent meeting.

Professors Heckert and Wilcox appeared on the program of the recent regional conference of N.A.C.A. chapters at Dayton.

University of Pennsylvania

One of the sessions of the Pennsylvania Institute of Certified Public Accountants, held at Dorshay, Pa. on June 21 was devoted to the topic of Accounting Education and the program was arranged by Professor J. Lockwood of the University of Pennsylvania. Papers on the subject were given by W. W. Nissley, C.P.A. New York State, R. H. Montgomery of Lybrand, Ross Bros., and Montgomery; George A. McFarland, University of Pennsylvania; Wilbur G. Collings Grove City College; and C. E. Allen, Lehigh University. All teachers of accounting in colleges and universities in Pennsylvania were invited to attend. A University and College Contact Committee, appointed last year, was continued.

Princeton University

Dr. Frank DeByver, instructor in accounting, has gone to Duke University, and Dr. E. D. Hawkins to Mount Holyoke College.

Edward S. Lynch and John P. Miller, both M.A.'s from Harvard University Graduate School, have been appointed instructors in the department.

University of Southern California

Professor H. D. Campbell of this department exchanged summer session teaching with Professor Albert J. Barlow of the University of Virginia.

A new two unit course in Accounting History and Theory has been added and also a three unit graduate course in Advanced Cost Problems.

University of Tennessee

Mr. J. D. Goeltz, from the Morris County Junior College, Morristown, N. J., has been added to the staff as instructor in accounting.

University of Texas

Dr. James C. Dolley has been promoted to the rank of associate professor and Mr. L. C. Haynes to assistant professor of business administration.

Mr. C. Aubrey Smith, associate professor of accounting, has returned to the department after a year's absence during which he served as accounting analyst in the examination division of the Securities and Exchange Commission at Washington, D.C.

Dr. John R. Stockton, who has been statistician with the Meredith Publishing Company at Des Moines, Iowa, has been appointed assistant professor of business administration in this department. Mr. Fladger F. Tannery, and Mr. Robert A. White have been made instructors.

University of Vermont

Professor L. L. Briggs is publishing the *Accountants' Digest* which has now been subscribed to by several thousand accountants in the United States, Canada, and England.

American Association of University Instructors In Accounting

Program of the Twentieth Annual Convention

Commodore Hotel, New York City

Friday, December 27, 1935

Morning Session—9:30 a.m.

GENERAL TOPIC: ACCOUNTING THEORY

CHAIRMAN: George O. May Price, Waterhouse & Co.

PAPERS: William Morse Cole, Harvard University, What Do We Mean By Cost
A. C. Littleton, University of Illinois, Changing Theories of Income
H. R. Hatfield, University of California, Theories of Depreciation
W. A. Paton, University of Michigan, The Valuation of a Business Enterprise

Afternoon Session—1:30 p.m.

CHAIRMAN: Harvey G. Meyer, First vice-president A.A.U.I.A.

PAPERS: Roy B. Kester, Columbia University, Education for Professional Accounting
STANLEY B. HOWARD, Princeton University, Accounting Instruction in the Liberal Arts Curriculum
Ira N. Frisbee, University of California at Los Angeles, Accounting for Income of Municipalities
C. Rufus Rorem, Hospital Accounting

Annual Dinner—7:00 p.m.

HONORING 18 PAST PRESIDENTS. (All except two have agreed to attend.)
Chairman of Dinner Committee: Arthur H. Rosenkampff, New York University.
Toastmaster: John R. Wildman (First President A.A.U.I.A.)

ADDRESSES: H. T. Scovill, University of Illinois
John T. Madden, New York University
J. O. McKinsey, University of Chicago
H. R. Hatfield, University of California

Saturday, December 28, 1935

Morning Session—9:30 a.m.

GENERAL TOPIC: Joint meeting with Association of Teachers of Business Law
CO-CHAIRMEN: Nathan Isaacs, Harvard University—A.T.B.L.
F. H. Elwell, University of Wisconsin—A.A.U.I.A.

PAPERS: Thomas H. Sanders, Harvard University, Influence of the Securities & Exchange Commission on Accounting Principles
David A. Buckley, Tax Litigation Before the Tax Unit in Washington, Discussion by James L. Dohr
Paul M. Green, University of Illinois, Some Problems in Government Accounting
M. T. Carey, University of Pennsylvania

Afternoon Session—2:00 p.m.

GENERAL TOPIC: Business Meeting
Reports of Regular Committees
Reports of Special Committees
Unfinished Business
Election of Officers

THE AMERICAN ASSOCIATION OF UNIVERSITY INSTRUCTORS IN ACCOUNTING

Committees-1935

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